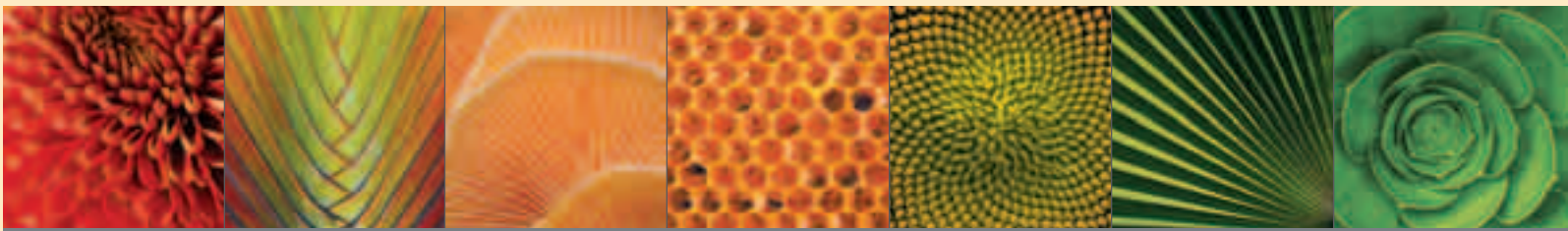


HONG KONG MONETARY AUTHORITY ANNUAL REPORT 2005



HONG KONG MONETARY AUTHORITY
香港金融管理局

THE HONG KONG MONETARY AUTHORITY

Established in April 1993, the Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability. The HKMA's policy objectives are

- to maintain currency stability, within the framework of the Linked Exchange Rate system, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.


The photographs

The theme photographs in this Annual Report show patterns found in the natural environment in Hong Kong. These patterns suggest stability, consistency, growth and health.

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The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2005 submitted by the Monetary Authority to the Financial Secretary in accordance with Section 9 of the Banking Ordinance.

This Annual Report makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as , followed by navigation guidance from the HKMA homepage.

The full text of this Report is available on the HKMA website in interactive form and on PDF files.

A summary version of this Report is also available in *An Introduction of the Hong Kong Monetary Authority 2006 Edition*.

All amounts in this Report are in Hong Kong dollars unless otherwise stated.

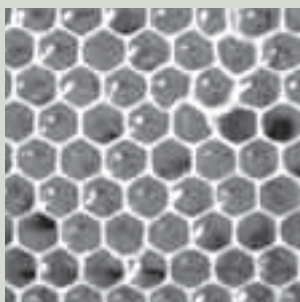
HIGHLIGHTS OF 2005



Economic and Banking Environment

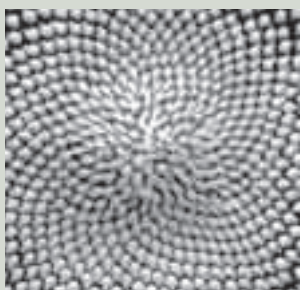
Hong Kong's economy enjoys remarkable growth in 2005. Real GDP grows by 7.3%.

Retail banks record healthy profit growth as the buoyant domestic economy helps improve the operating environment.



Monetary Stability

Refinements to the operation of the Linked Exchange Rate system introduced in May 2005 make the interest rate adjustment mechanism more efficient.



Banking Stability

The HKMA continues to develop the risk-based supervisory approach following its full implementation in 2004.

The first review of positive credit data sharing shows that there have been benefits to financial institutions and consumers.

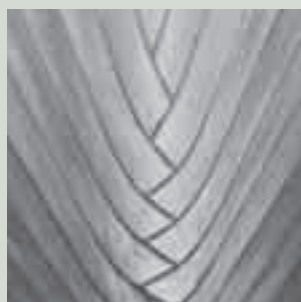
The Banking (Amendment) Ordinance 2005 is enacted. The Ordinance gives express statutory backing for the implementation of Basel II in Hong Kong.



Market Infrastructure

The HKMA continues to develop a safe and efficient multi-currency, multi-dimensional clearing and settlement platform.

The Treasury Markets Association is established to provide a solid structure for developing the treasury markets of Hong Kong.



International Financial Centre

Renminbi services are expanded. Total outstanding renminbi deposits in Hong Kong exceed RMB22 billion yuan at the end of 2005.

Two key components of Asian Bond Fund 2, the Pan Asia Bond Index Fund and ABF Hong Kong Bond Index Fund, are listed in Hong Kong.



Reserves Management

The Exchange Fund achieves an investment return of 3.1% in 2005.

Hong Kong's foreign currency reserves stand at US\$125.3 billion at the end of 2005.

CHIEF EXECUTIVE'S STATEMENT



Favourable economic trends

Hong Kong enjoyed robust economic growth in 2005, following a strong and broad-based recovery in 2004. Real GDP grew by a healthy 7.3%, slightly lower than the 8.6% growth in 2004, which reflected the rebound from the SARS outbreak in the previous year. The unemployment rate continued to decline to a four-year low of 5.3% at the end of December, well down from its historic peak of 8.6% in mid-2003, although still high by historical standards. Exports of goods and services increased by 11.2% and 8.4% respectively in 2005, reflecting solid growth among Hong Kong's trading partners. Despite higher interest rates and a moderation in the property market towards the end of the year, private consumer and investment spending both increased.

Factors contributing to Hong Kong's robust performance in 2005 included strong growth in the US economy (despite high oil prices and the gradual removal of the Federal Reserve's accommodative monetary policy) and solid growth among our other major trading partners, which supported our export performance. Private consumption rebounded as a result of increasing employment and household income. The property market continued to recover, further reducing the number of residential property mortgages in negative equity, which, despite rising slightly towards the end of the year as property prices moderated, has come down by about 90% from its peak in mid-2003. Interest rates caught up with their US counterparts and tracked them fairly closely in the second half of the year. Inflation returned in 2005, with the year-on-year change in the Composite Consumer Price Index reaching 1.8% in December and averaging 1.1% for the year. This was the first increase for seven years and inflationary pressure remains benign.

Mixed markets

2005 saw a significant rise in energy prices and the continued removal of the accommodative stance in the monetary policy of the US Federal Reserve. The price of benchmark crude oil rose from US\$43.5 a barrel at the beginning of the year to US\$61 at the end. The Fed continued to increase the federal funds target rate, which was raised eight times in 2005 to end the year at 4.25%. Global equity markets showed mixed results; improving economic prospects in Japan caused the TOPIX to rise by 43.5%, while the euro-zone stock indices rose by 13% to 33%. The US and Hong Kong equities markets fared less well with the S&P 500 rising by 3.0% and the Hang Seng Index by 4.5%.

The investment objectives of the Exchange Fund emphasise capital preservation and liquidity because the Exchange Fund must be available for backing the Monetary Base to safeguard the exchange value of the Hong Kong dollar. This sets the Fund apart from conventional investment funds, which seek to maximise returns. The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment of the Fund and the need to diversify into new markets and instruments. Despite the difficult investment environment in 2005, in particular the strengthening of the US dollar, which affected the value of the Exchange Fund's non-US-dollar holdings, the Exchange Fund earned an investment income of \$38.2 billion in 2005, and a rate of return exceeding that of the investment benchmark approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC) by more than 0.2%. The share of investment income going to the fiscal reserves placed with the Exchange Fund was \$10 billion.

Hong Kong dollar stability

The exchange and money markets were largely stable during the year despite massive fund flows with a record \$166 billion being raised locally arising from initial public offerings in the stock market, including \$72 billion for a single offering. There were also speculative inflows, particularly in the first few months of the year, as the Hong Kong dollar was used as a proxy by people taking a position on the renminbi. Market sentiment was that the Hong Kong dollar would appreciate alongside the renminbi when flexibility was introduced into the exchange rate of the latter. This position-taking had widened the interest rate differentials between the Hong Kong dollar and the US dollar, and resulted in very easy monetary conditions, which could be destabilising if they were sustained.

To normalise the situation, on 18 May the HKMA introduced the three refinements to the Linked Exchange Rate system. The intention behind the three refinements was to remove the uncertainty about the extent to which the Hong Kong dollar would be allowed to appreciate against the US dollar. Anchoring exchange rate expectations on the strong side would discourage speculative inflows and allow interest rate arbitrage to exert a greater influence in the maintenance of a stable exchange rate. This proved to be the case when, following the announcement, expectations of an appreciation in the Hong Kong dollar diminished, speculative inflows reversed and the weak-side Convertibility

Undertaking was triggered. The Aggregate Balance swiftly declined and interest rates rose, reflecting the tightening of interbank liquidity following the introduction of the three refinements, tracking their US counterparts quite closely for the remainder of the year. When the reform of the renminbi exchange rate system was announced in July, the Hong Kong dollar exchange rate was barely affected, suggesting that the three refinements had achieved their purpose.

A strong and stable banking sector

The banking sector continued to perform strongly in 2005 benefiting from the buoyant domestic economy with aggregate pre-tax operating profits of retail banks' Hong Kong offices increasing by 8.2%. Both increases in net interest income and non-interest income contributed to this growth in profits with the share of non-interest income increasing to 40.9% from 39.3% in 2004. Total lending by retail banks grew by 9.8% in 2005. The average net interest margin of retail banks for the year increased slightly to 1.68% compared with 1.66% in 2004 despite pressure in the first half due to excess liquidity. Asset quality continued to improve in 2005 as a result of improvements in the domestic economy, the labour market and property values. The classified loan ratio declined to 1.38% from 2.25% at the end of 2004. Retail banks remained highly liquid in 2005, although loan-to-deposit ratios increased. The capital adequacy ratio of all authorized institutions declined slightly to 14.9% at the end of 2005, still well above the statutory minimum of 8%. Retail banks' operating costs increased during the year, mainly as a result of higher staff expenses, and the cost-to-income ratio rose to 41.9% from 41.4% in 2004. Continued competition and pressure on costs are likely to make the operating environment challenging for the banks in 2006.

The HKMA expanded its efforts to promote the safety and stability of the banking system in 2005, reorganising the Banking Supervision Department to make the risk-based approach to supervision more effective and increasing the number of on-site examinations. Further progress towards the implementation of Basel II was made with the enactment in July of the Banking (Amendment) Ordinance 2005 and consultation with the banks on the draft rules for implementing the capital adequacy standards. Hong Kong is among the first economies to introduce the improved risk-management regime under the Basel II initiative. Good progress has been made with the establishment of the Deposit Protection Board in preparation for the launch of the Deposit Protection Scheme in 2006. To improve the safety and security of Internet banking, two-factor authentication was launched jointly with the Hong Kong Association of Banks and the Police in May. Following the end of a two-year moratorium on the access to credit data by financial institutions for credit review, the HKMA conducted a review of the benefits of positive credit data sharing. The results showed clear benefits to consumers with a significant portion of credit card rollover balances being substituted by cheaper forms of non-card credit.

Developing Hong Kong as an international financial centre

Hong Kong continues to support the prevention of money laundering and terrorist financing by ensuring that the banking system adopts the latest and best practices issued by the standard-setters in this area. In 2005, the HKMA stepped up its efforts by conducting more examinations of anti-money laundering procedures in authorized institutions and sharing the findings with the banking industry to help them better understand the issues involved and prioritise their resources.

The HKMA was involved in several key initiatives to strengthen Hong Kong's status as an international financial centre. These included the successful launch of the second phase of the Asian Bond Fund initiative (ABF2), which comprises a number of local-currency denominated funds designed to strengthen and deepen regional bond markets. The component funds of ABF2 have been specifically designed to keep costs and investment thresholds low to appeal to a broader class of investors. Two key components launched in Hong Kong, the Pan Asia Bond Index Fund and the Hong Kong Bond Index Fund, have been well received by the market. This initiative, instigated by Hong Kong with the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), is widely seen as a model for successful co-operation in the development of financial markets in Asia.

The steady development of renminbi business in Hong Kong continued following its launch in 2004. Outstanding renminbi deposits in Hong Kong banks almost doubled to reach RMB 22.6 billion yuan at the end of December. In November the scope of renminbi business was expanded. The definition of designated merchants was widened and designated merchants are now allowed to open renminbi deposit accounts; Hong Kong residents are allowed to use renminbi cheques in Guangdong Province; limits on the exchange and remittance of renminbi by individuals have been relaxed; and the cap on credit limits for renminbi credit cards has been removed. Discussions with Mainland authorities are continuing about further expansion, including the settlement of trade transactions in Hong Kong in renminbi and the issuance of renminbi-denominated bonds in Hong Kong. Under Phase III of the Closer Economic Partnership Arrangement, the Mainland authorities agreed to relax the requirements regarding the amount of operating funds for Hong Kong banks to open branches on the Mainland to offer renminbi and foreign-currency business to local customers.

An important aspect of developing Hong Kong as an international financial centre is ensuring that it has a well developed and flexible financial infrastructure. The HKMA undertook a review of financial infrastructure development in the first half of 2005 with the objective of establishing a safe and efficient, multi-dimensional and multi-currency payment and settlement platform. While perhaps largely unnoticed by the general public, robust and effective clearing and payment systems help to keep the financial and monetary systems stable and competitive. The recommendations of the review are now being implemented. Highlights in 2005 included the re-launch of a refined scheme for retail investment in Exchange Fund Notes, the launch of the CMU Bond Price Bulletin for

retail investors, and the development of the RTGS Liquidity Optimiser to help banks better manage their intraday liquidity. Preparation also began during the year for the establishment of an automated renminbi settlement system to cater for the expanded scope of renminbi business in Hong Kong and the migration of the Real Time Gross Settlement system and Central Moneymarkets Unit from a proprietary platform to the SWIFTNet open platform to allow greater international participation. Payment links with the Mainland have also been developed to meet increasing demand following the rapid increase in economic activities between the Mainland and Hong Kong. The establishment of the Treasury Markets Association is also a major step forward in our effort to promote the treasury markets of Hong Kong and enhance the professionalism of market practitioners.

Governance and transparency

The HKMA is an integral part of the Hong Kong Special Administrative Region Government but, like central banking institutions elsewhere in the world, we maintain a degree of separation from the main structure of government. This is reflected in the autonomy given to the HKMA in its daily operation, in our funding arrangements, and in our employment of staff on terms different from those of the civil service. There are sound reasons for these arrangements: they are consistent with the generally accepted principle that central banking institutions should have resource independence to allow them to pursue their objectives without political influence. This independence allows the HKMA to do its job flexibly in an environment that is often changing rapidly and, when necessary, to take steps that might not be popular in the short term but which are necessary to achieve the Financial Secretary's stated policy objective of ensuring exchange rate stability. But the HKMA is funded by public money and responsible for the management of over a trillion dollars of public funds. It is therefore right and necessary that there should be a system of accountability to balance our operational autonomy, and the HKMA is accountable to the Financial Secretary through EFAC, and to the community, both directly and through its elected representatives on the Legislative Council. My thrice-yearly briefings of the Legislative Council's Financial Affairs Panel on the work of the HKMA have become an established and important channel for keeping Members, and the wider community, informed about what we are doing and developments in the monetary, financial and banking fields.

2005 was the first full year of operation for the expanded system of EFAC Sub-Committees introduced in 2004. The arrangements functioned well and the Sub-Committees' responsibilities and activities during the year are summarised in the "About the HKMA" chapter.

The HKMA makes great efforts to explain its work to the community it serves through its publications, public education programmes and website. In 2005, the HKMA's website received over 21 million page views, a 40% increase from 2004. I took great pleasure in welcoming the hundred-thousandth visitor to the HKMA Information Centre in December; more than 110,000 people have now visited the Centre since it opened in late 2003. This policy of accessibility is a two-way process, allowing the community to know more about what we do and helping us to keep in touch with people's views about our work and the policies we pursue.

The staff establishment of the HKMA again remained stable in 2005 despite our having expanded our work and taken on a number of new responsibilities. Following approval by the Financial Secretary, on the advice of EFAC and its Governance Sub-Committee, the staff establishment was increased by 10 posts at the beginning of 2006 to 614 to help the HKMA cope with a considerably expanded workload in a number of key areas including the prevention of money laundering, supervision of banks' securities business and financial links with the Mainland. I would like to thank staff of the HKMA for their hard work and dedication during another challenging year.

My colleagues and I are also grateful to the Financial Secretary and to Members of EFAC for their continued guidance and support.



Joseph Yam
Chief Executive

ABOUT THE HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

THE HKMA'S LEGAL MANDATE

The HKMA was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. To enable the establishment of the HKMA, the Legislative Council passed amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority.

The powers, functions and responsibilities of the Monetary Authority are set out in the Exchange Fund Ordinance, the Banking Ordinance, the Deposit Protection Scheme Ordinance, the Clearing and Settlement Systems Ordinance and other relevant Ordinances. The division of functions and responsibilities in monetary and financial affairs between the Financial Secretary and the Monetary Authority is set out in an Exchange of Letters between the two dated 25 June 2003. This Exchange of Letters also discloses the delegations made by the Financial Secretary to the Monetary Authority under these Ordinances. The letters are public documents: copies of them may be found on the HKMA website.

The Exchange Fund Ordinance establishes the Exchange Fund under the control of the Financial Secretary. According to the Ordinance, the Fund shall be used primarily for affecting the exchange value of the Hong Kong dollar. It may also be used for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre.

The Monetary Authority is appointed under the Exchange Fund Ordinance to assist the Financial Secretary in performing his functions under the Exchange Fund Ordinance and to perform such other functions as are assigned by other Ordinances or by the Financial Secretary. The office of the Monetary Authority is known as the HKMA, and the Monetary Authority as the Chief Executive of the HKMA.

The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. Under the Ordinance, the Monetary Authority is responsible, among other things, for the authorization of licensed banks, restricted licence banks, and deposit-taking companies in Hong Kong.

The Clearing and Settlement Systems Ordinance provides a statutory regime for the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre.

Under the Deposit Protection Scheme Ordinance the Monetary Authority is charged with implementing the decisions of the Hong Kong Deposit Protection Board, and among other things, deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.

 > [The HKMA](#)

THE HKMA AND THE HONG KONG SAR GOVERNMENT

The HKMA is an integral part of the Hong Kong SAR Government, but is able to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. The Chief Executive of the HKMA remains a public officer, as do his staff. In its day-to-day work the HKMA operates with a high degree of autonomy within the relevant statutory powers conferred upon, or delegated to, the Monetary Authority.

The Financial Secretary is responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong: a letter from the Financial Secretary to the Monetary Authority dated 25 June 2003 specifies that these should be currency stability defined as a stable exchange value at around HK\$7.80 to one US dollar maintained by Currency Board arrangements. The Monetary Authority is on his own responsible for achieving the monetary policy objective, including determining the strategy, instruments and operational means for doing so. He is also responsible for maintaining the stability and integrity of the monetary system of Hong Kong.

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong

Kong as an international financial centre. In support of these policies, the Monetary Authority is responsible, among other things, for

- promoting the general stability and effective working of the banking system
- promoting the development of the debt market, in co-operation with other relevant bodies
- matters relating to the issuance and circulation of legal tender notes and coins
- promoting the safety and efficiency of the financial infrastructure through the development of payment, clearing and settlement systems and, where appropriate, the operation of these systems
- seeking to promote, in co-operation with other relevant bodies, confidence in Hong Kong's monetary and financial systems, and appropriate market development initiatives to help strengthen the international competitiveness of Hong Kong's financial services.

The Exchange Fund is under the control of the Financial Secretary. The Monetary Authority, under delegation from the Financial Secretary, is responsible to the Financial Secretary for the use of the Exchange Fund, and for the investment management of the Fund.

ACCOUNTABILITY AND TRANSPARENCY

The autonomy given to the HKMA in its day-to-day operations, and in the methods it uses to pursue policy objectives determined by the Government, is complemented by a high degree of accountability and transparency.

The HKMA serves Hong Kong by promoting monetary and banking stability, by managing the official reserves effectively, and by developing and overseeing a robust and diverse financial infrastructure. These processes help to strengthen Hong Kong's role as an international financial centre and to foster Hong Kong's economic well-being. The HKMA must have the confidence of the community if it is to perform its duties well. The HKMA therefore takes seriously the duty of explaining its policies and work to the general public and makes every effort to address any concerns within the community relevant to the HKMA's responsibilities.

The HKMA is accountable to the people of Hong Kong through the Financial Secretary, who appoints the Monetary Authority, and through the laws passed by the Legislative Council that set out the Monetary Authority's powers and responsibilities. The HKMA also recognises a broader responsibility to promote a better understanding of its roles and objectives and to keep itself informed of community concerns. In its day-to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

The HKMA seeks to follow international best practices in its transparency arrangements. It maintains extensive relations with the mass media and produces a range of regular and special publications in both English and Chinese. The HKMA's bilingual website (www.hkma.gov.hk) carries all HKMA publications, press releases, speeches and presentations, in addition to special sections on research, statistics, consumer information and other topics. The HKMA maintains an Information Centre at its offices, consisting of a library and an exhibition area, which is open to the public six days a week. The HKMA also organises an annual public education programme, which seeks to inform the public, and in particular students, about the work of the HKMA through seminars and guided tours at the Information Centre. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services.

 > [Viewpoint](#)

 > [HKMA Information Centre](#)

Over the years the HKMA has progressively increased the detail and frequency of its disclosure of information on the Exchange Fund and Currency Board Accounts. Since 1999 the HKMA has participated in the International Monetary Fund's Special Data Dissemination Standard project for central banks. The HKMA publishes records of meetings of the Exchange Fund Advisory Committee Currency Board Sub-Committee, along with the monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

The relations between the HKMA and the Legislative Council play an important part in the process of accountability and transparency. There is a formal commitment from the Chief Executive of the HKMA to appear before the Legislative Council Panel on Financial Affairs three times a year to brief Members and to answer questions on the HKMA's work. At one of these briefings, usually in May, the HKMA's Annual Report is presented. In addition, staff from the HKMA attend Legislative Council Panel meetings to explain and discuss particular issues, and Committee meetings to assist Members in their scrutiny of draft legislation.

 > [Legislative Council Issues](#)

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

In his control of the Exchange Fund, the Financial Secretary is advised by the Exchange Fund Advisory Committee (EFAC). EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. The Financial Secretary is ex officio Chairman of EFAC. Other members, including the Monetary Authority, are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR. Members of EFAC are appointed for the expertise and experience that they can bring to the committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC advises the Financial Secretary on investment policies and strategies for the Fund and on projects, such as the development of financial infrastructure, that are charged to the Fund. Since the operating and staff costs of the HKMA are also chargeable to the Exchange Fund, EFAC advises the Financial Secretary on the HKMA's annual administration budget and on the terms and conditions of service of HKMA staff. EFAC meets regularly and on other occasions when particular advice is being sought.

EFAC is assisted in its work by five subcommittees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six regular meetings in 2005 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees. An additional meeting was held in May to discuss the refinements to the Linked Exchange Rate mechanism introduced on 18 May 2005.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met seven times in 2005 to consider a range of subjects including disclosure of information on the HKMA's expenditure budget, the HKMA's performance in 2004, the 2005 annual pay review, the *2004 HKMA Annual Report*, business continuity planning, strategic planning matters and the 2006 HKMA budget. The Sub-Committee also received regular reports on the work of the HKMA.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. The Sub-Committee met three times in 2005. In addition to regular reports, the Sub-Committee reviewed a consultancy report on the implementation of Hong Kong Financial Reporting Standards and assessed its impact on the Exchange Fund Accounts.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible, among other things, for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted monthly to the Sub-Committee are published. In 2005 the Sub-Committee met six times. Topics discussed included a monetary conditions index for Mainland China, convertibility arrangements for the Aggregate Balance and operations within the Convertibility Zone, transferability between Certificates of Indebtedness and the Aggregate Balance, and the implications of the new renminbi exchange rate regime for Hong Kong.

 > [Press Releases > Monetary Policy](#)

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held six meetings during 2005 to give advice on the investment strategy of the Exchange Fund and related issues.

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure. In 2005 the Sub-Committee met four times. The subjects discussed included the review of financial infrastructure development, progress of project and business development arising from the review, and the establishment of the Treasury Markets Association.

The Banking Advisory Committee

The Banking Advisory Committee is established under Section 4(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

The Deposit-Taking Companies Advisory Committee

The Deposit-Taking Companies Advisory Committee is established under Section 5(1) of the Banking Ordinance to advise the Chief Executive of the Hong Kong SAR on matters relating to the Banking Ordinance, in particular matters relating to deposit-taking companies and restricted licence banks and the carrying on of a business of taking deposits by them. The Committee consists of the Financial Secretary, who is the Chairman, the Monetary Authority, and other persons appointed by the Financial Secretary under the delegated authority of the Chief Executive of the Hong Kong SAR.

Chief Executive's Committee

The Chief Executive's Committee is chaired by the Chief Executive of the HKMA and consists of the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets weekly to report to the Chief Executive on the progress of major tasks being undertaken by the various departments of the HKMA and to advise him on policy matters relating to the operations of the HKMA.

The membership lists of the various Committees and Sub-Committees are given on pages 16 to 28. Brief biographies and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members of EFAC, is available for public inspection during office hours (9:00 a.m. to 5:00 p.m. Monday to Friday and 9:00 a.m. to 12 noon Saturday) at the HKMA Offices, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.

 > [The HKMA > Advisory Committees](#)

 > [The HKMA > The Chief Executive's Committee](#)

ADVISORY COMMITTEES

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP
The Financial Secretary

Members

Mr Joseph YAM, GBS, JP
The Monetary Authority

Dr The Hon. David LI Kwok-po, LLD, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Dr The Hon. Marvin CHEUNG Kin-tung,
DBA Hon., SBS, JP

Professor Richard Y C WONG, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

The Hon. Victor LO Chung-wing, GBS, JP
Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited



Peter Sullivan

Simon Ip

K C Chan

Patrick Wang

Christopher Cheng

Marvin Cheung

Joseph Yam

Mr HE Guangbei

Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

Professor K C CHAN

Dean of Business and Management
Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director
CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP

Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited
(from 6 June 2005)

Mr David ELDON, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited
(until 30 April 2005)

Secretary

Mr Trevor KEEN

(from 1 August 2005)

Mr Christopher MUNN

(until 31 July 2005)



Henry Tang

David Li

Richard Wong

Victor Lo

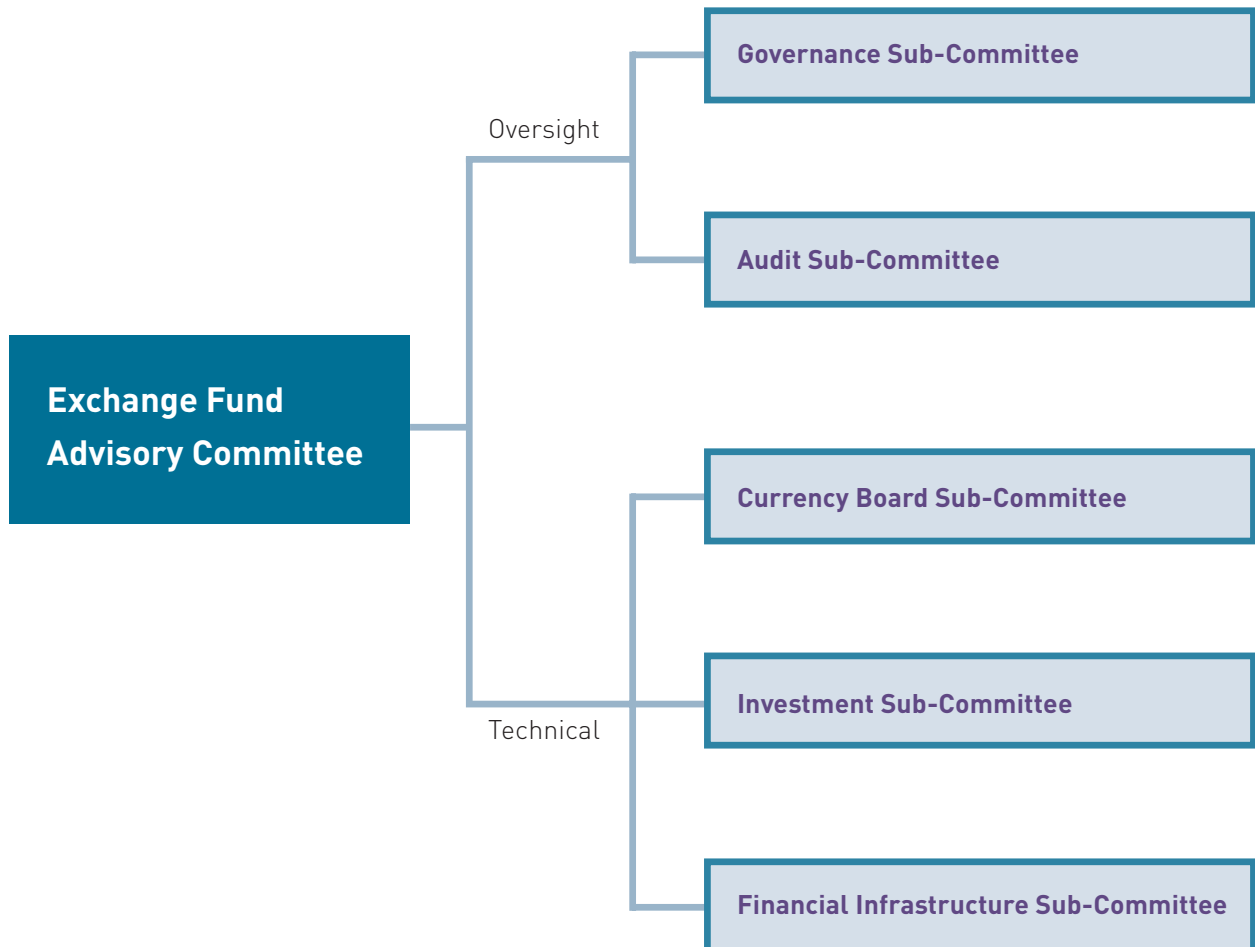
He Guangbei

Henry Fan

Thomas Kwok

Vincent Cheng

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



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Johnson Electric Holdings Limited

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Mr Thomas KWOK Ping-kwong, JP
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(from 1 August 2005)

Mr Christopher MUNN
(until 31 July 2005)

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(from 7 January 2005)

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(from 1 June 2005)

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(from 6 June 2005)

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(until 30 April 2005)

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(from 1 August 2005)

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(until 31 July 2005)

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Mr Peter PANG, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority
(from 1 June 2005)

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Deputy Vice-Chancellor
The University of Hong Kong

Mr John GREENWOOD

Group Chief Economist
INVESCO Asset Management Limited

Professor TSANG Shu-ki

Department of Economics
Hong Kong Baptist University

Professor K C CHAN

Dean of Business and Management
Hong Kong University of Science and Technology

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Chairman
The Hong Kong Association of Banks

Mr Norman CHAN

, SBS, JP

Deputy Chief Executive
Hong Kong Monetary Authority
(until 26 May 2005)

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(from 1 August 2005)

Mr Christopher MUNN

(until 31 July 2005)

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USI Holdings Limited

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Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

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Dean of Business and Management
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Managing Director
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Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
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Mr Vincent CHENG Hoi-chuen, GBS, JP
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(from 6 June 2005)

Mr Norman CHAN, SBS, JP
Deputy Chief Executive
Hong Kong Monetary Authority
(until 26 May 2005)

Mr David ELDON, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited
(until 30 April 2005)

Secretary

Mr Trevor KEEN
(from 1 August 2005)

Mr Christopher MUNN
(until 31 July 2005)

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The Monetary Authority

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(from 1 June 2005)

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Chairman and Chief Executive
The Bank of East Asia Limited

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

Dr Patrick WANG Shui-chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

Mr HE Guangbei
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited

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Managing Director
CITIC Pacific Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman

The Hongkong and Shanghai Banking Corporation Limited
(from 6 June 2005)

Mr Peter PANG, JP

Deputy Chief Executive
Hong Kong Monetary Authority
(until 31 May 2005)

Mr Norman CHAN, SBS, JP

Deputy Chief Executive
Hong Kong Monetary Authority
(until 26 May 2005)

Mr David ELDON, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited
(until 30 April 2005)

Secretary

Mr Trevor KEEN

(from 1 August 2005)

Mr Christopher MUNN

(until 31 July 2005)

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The Financial Secretary

Ex Officio Member

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The Monetary Authority

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Representing The Hongkong and
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(from 1 April 2005)

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Executive Director and Chief Executive Officer
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Mrs Mignonne CHENG
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Ms Maria XUEREB
Financial Services Partner
Deloitte Touche Tohmatsu

Mr Ignatius CHAN Tze-ching, JP
Citigroup Country Officer, Hong Kong & Head of Greater China
Corporate and Investment Banking
Citibank, N.A.
(from 1 December 2005)

Mr Hideo HIYAMA
Director, General Manager & Regional Chief Executive
Sumitomo Mitsui Banking Corporation
Hong Kong Branch
(from 1 December 2005)

Mr Randolph G SULLIVAN
Chief Executive Officer
DBS Bank (Hong Kong) Limited
(from 1 December 2005)

Mr James C K WONG
Chief Executive Officer
The Prudential Assurance Co. Ltd.
(from 1 December 2005)

Mrs Angelina P L LEE, JP
Partner
Woo, Kwan, Lee & Lo
Solicitors and Notaries
(until 30 November 2005)

Mr Tatsuo TANAKA
Managing Director and Chief Executive Officer for Asia and Oceania
The Bank of Tokyo-Mitsubishi, Ltd
(until 30 November 2005)

Mr Samuel N TSIEN
President and Chief Executive Officer
Bank of America (Asia) Limited
(until 30 November 2005)

Mr David S Y WONG, JP
Chairman
Dah Sing Bank Limited
(until 30 November 2005)

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Executive Director
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Representing The Hongkong and
Shanghai Banking Corporation Limited
(until 31 March 2005)

Secretary

Ms Ida LIU
(from 14 February 2005)

Ms Carman CHIU
(until 13 February 2005)

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Ex Officio Member

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The Monetary Authority

Members

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Secretary for Financial Services and the Treasury

Mr Martin WHEATLEY

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Securities and Futures Commission
Representing The Securities and Futures Commission
(from 1 October 2005)

Mrs Pamela CHAN WONG Shui

, BBS, JP

Chief Executive
Consumer Council
Representing The Consumer Council

Mr Geoffrey J MANSFIELD

Chairman
Hong Kong Association of Restricted Licence Banks and
Deposit-Taking Companies (The DTC Association)
Representing The DTC Association
(from 2 December 2005)

Mr Mervyn JACOB

Partner
Assurance, Financial Services practice
PricewaterhouseCoopers

Mr Erik Helge WEINER

Chairman & Chief Executive
JP Morgan Securities (Asia Pacific) Limited
(from 17 August 2005)

Dr Eric K C LI

, GBS, JP

Senior Partner
Li, Tang, Chen & Co
Certified Public Accountants (Practising)

Mr TAN Yoke-kong

General Manager
JCG Finance Company, Limited

Mr Frank J WANG

Executive Director and Deputy Chief Executive
Wing Hang Finance Company Limited

Ms Kitty IU Pui-pui

Managing Director
Scotiabank (Hong Kong) Limited
(from 21 December 2005)

Mr MOK Wai-kin

Director
Hang Seng Finance Limited
(until 31 December 2005)

Mr Clifford FORSTER

Chairman
Hong Kong Association of Restricted Licence Banks and
Deposit-Taking Companies (The DTC Association)
Representing The DTC Association
(until 1 December 2005)

Mr Geoffrey J MANSFIELD

Director
PrimeCredit Limited
(until 1 December 2005)

Mr Andrew SHENG

, SBS, JP

Chairman
Securities and Futures Commission
Representing The Securities and Futures Commission
(until 30 September 2005)

Mr POON Kwok-yuen

President and Chief Executive Officer
AIG Finance (Hong Kong) Limited
(until 20 July 2005)

Mr Andrew KUO

Managing Director
JP Morgan Securities (Asia Pacific) Limited
(until 2 June 2005)

Mr Kasem TAECHAWATANATHORN

President & Chief Executive Officer
GE Capital (Hong Kong) Limited
(from 17 August until 30 November 2005)

Secretary

Ms Ida LIU

(from 14 February 2005)

Ms Carman CHIU

(until 13 February 2005)

CHIEF EXECUTIVE'S COMMITTEE



CHIEF EXECUTIVE

Joseph YAM, GBS, JP

Joseph Yam has served as Chief Executive of the HKMA since its establishment in April 1993. Mr Yam began his civil service career in Hong Kong as a Statistician in 1971, and became an Economist in 1976. His involvement in monetary affairs in Hong Kong started when he was appointed Principal Assistant Secretary for Monetary Affairs in 1982. He helped put together Hong Kong's Linked Exchange Rate system in 1983. He was subsequently appointed Deputy Secretary for Monetary Affairs in 1985 and Director of the Office of the Exchange Fund in 1991.



DEPUTY CHIEF EXECUTIVE

William RYBACK, JP

William Ryback is in charge of the full range of banking policy, development and supervision issues. Prior to joining the HKMA in 2003, Mr Ryback was Senior Associate Director of the Division of Bank Supervision at the Board of Governors of the Federal Reserve System in Washington, D.C.. He was also Chairman of the Board of Directors of the Association of Bank Supervisors of the Americas. He was the Board of Governors representative on the Basel Committee on Banking Supervision from 1986 to 1994.



DEPUTY CHIEF EXECUTIVE

Peter PANG, JP

Peter Pang is responsible for external affairs, corporate services and research. Mr Pang joined the HKMA as Executive Director (Banking Policy) in 1994 and was appointed Executive Director (Monetary Policy and Markets) in 1996. He was the Chief Executive Officer of the Hong Kong Mortgage Corporation from 1997 to 2004. He was appointed to his present position in July 2004. Mr Pang joined the civil service as an Administrative Officer in 1979 and served as Assistant Director General of Trade and Assistant Commissioner of Banking before joining the HKMA.



DEPUTY CHIEF EXECUTIVE

Y K CHOI, JP

Y K Choi is responsible for monetary management, financial infrastructure, reserves management, and strategy and risk. He joined the HKMA as Head (Banking Policy) in 1993 and was appointed Executive Director (Banking Supervision) in 1995 before being appointed to his present position in June 2005. Mr Choi joined the Office of the Commissioner of Banking in 1974. He became Assistant Commissioner of Banking in 1990 and was seconded to the Office of the Exchange Fund in 1991 with responsibility for currency stability and debt market development before joining the HKMA.

DEPUTY CHIEF EXECUTIVE

Norman Chan, SBS, JP

Norman Chan, who left the HKMA in May 2005, was responsible for reserves management and international finance.

**GENERAL COUNSEL****Stefan GANNON, JP**

Stefan Gannon has been General Counsel of the HKMA since its establishment in 1993. A barrister, Mr Gannon was the Legal Adviser to the Monetary Affairs Branch of the Hong Kong Government from 1987 to 1993.

**EXECUTIVE DIRECTOR
(BANKING DEVELOPMENT)****Raymond LI, JP**

Raymond Li is responsible for banking sector reform and development, licensing matters, enforcement on securities activities and oversight of clearing and settlement systems. Mr Li joined the Hong Kong Government as an Administrative Officer in 1982 and became Principal Assistant Secretary (Monetary Affairs) in 1990. He was appointed Head (Banking Development) at the HKMA in 1993 and took up the post of Head (Administration) in 1995. He was promoted to Executive Director (Banking Policy) in 1996. Before being appointed to his present position in June 2005, he was Executive Director (Corporate Services).

**EXECUTIVE DIRECTOR
(EXTERNAL)****Julia LEUNG, JP**

Julia Leung is responsible for international affairs relating to multilateral agencies and central bank co-operation, China research, financial market integration issues, as well as the HKMA's overseas offices in New York and London. Ms Leung joined the HKMA in 1994 as Senior Manager. She was promoted to Division Head in 1996, and was appointed to her present position in April 2000.

**EXECUTIVE DIRECTOR
(BANKING POLICY)****Simon TOPPING, JP**

Simon Topping is responsible for the development of banking supervisory policies on Basel II, risk management, anti-money laundering, and accounting and disclosure. He joined the HKMA in 1995 as a Division Head in the Banking Supervision Department and was appointed to his present position in September 2000. Prior to joining the HKMA he worked for the Bank of England and the International Monetary Fund.



**EXECUTIVE DIRECTOR
(MONETARY MANAGEMENT AND
INFRASTRUCTURE)**

Eddie YUE, JP

Eddie Yue is responsible for monetary management and financial infrastructure. Mr Yue began his career as an Administrative Officer in the Hong Kong Government in 1986. He joined the HKMA in 1993 as a Senior Manager, and was subsequently promoted to Division Head in 1994. He has worked in a number of divisions, including Monetary Management, External Relations, and Banking Development, and has served as Administrative Assistant to the Chief Executive of the HKMA. Mr Yue was appointed Executive Director (Corporate Services) in June 2001 and to his present position in July 2004.



**EXECUTIVE DIRECTOR
(BANKING SUPERVISION)**

Arthur YUEN, JP

Arthur Yuen is responsible for banking supervision. He joined the HKMA in 1996 as Head of Administration and has since taken up different responsibilities including research and liaison on Mainland China economic and market development issues before being appointed Head of Banking Supervision in 2000. He took up the position as Executive Director (Banking Development) in July 2004. He was appointed to his present position in June 2005. Before joining the HKMA, Mr Yuen worked in the Hong Kong Securities and Futures Commission for two years after having served as an Administrative Officer in the Hong Kong Government for over eight years.



**EXECUTIVE DIRECTOR
(RESEARCH)**

Hans GENBERG

Hans Genberg is responsible for research on issues related to monetary policy and financial markets. He is also Director of the Hong Kong Institute for Monetary Research. He was professor of economics at the Graduate Institute of International Studies in Geneva, Switzerland since 1979, and for a number of years he was the Head of its Economic Section before joining the HKMA in early 2005. He has also been a visiting scholar at the International Monetary Fund and the World Bank. He has published widely on issues related to monetary and exchange rate policy, and has a keen interest in monetary and financial developments in East Asia.



**EXECUTIVE DIRECTOR
(STRATEGY AND RISK)**

Edmond LAU

Edmond Lau is responsible for examining and developing strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change. Mr Lau joined the HKMA in 1997 as Head (Banking Development) and has been involved in banking reform and the establishment of the Deposit Protection Scheme. He took up the position as Administrative Assistant to the Chief Executive of the HKMA in 2004 after a one-year secondment to the Financial Services and Treasury Bureau. Before joining the HKMA Mr Lau was an Administrative Officer in the Hong Kong Government.



**EXECUTIVE DIRECTOR
(CORPORATE SERVICES)**

Christopher MUNN

Christopher Munn is responsible for corporate development, human resources, administration, finance and information technology. Mr Munn joined the HKMA in 1998 as Senior Manager (Corporate Development) and served as Head (Corporate Development) from 1999 to 2005.



**EXECUTIVE DIRECTOR
(RESERVES MANAGEMENT)**

Francis CHU

Francis Chu is responsible for the investment management of the Exchange Fund. Mr Chu joined the HKMA in 1995 as a Senior Manager in the Monetary Operations Division. He was promoted to Head (Monetary Operations) in 1996. From 2002 to 2004 he was the HKMA's Chief Representative in New York. Since returning to Hong Kong in 2004 he served again as Head (Monetary Operations) before his promotion to his current position. Before joining the HKMA, Mr Chu worked for more than 15 years in senior management and treasury positions in the banking sector in Hong Kong.



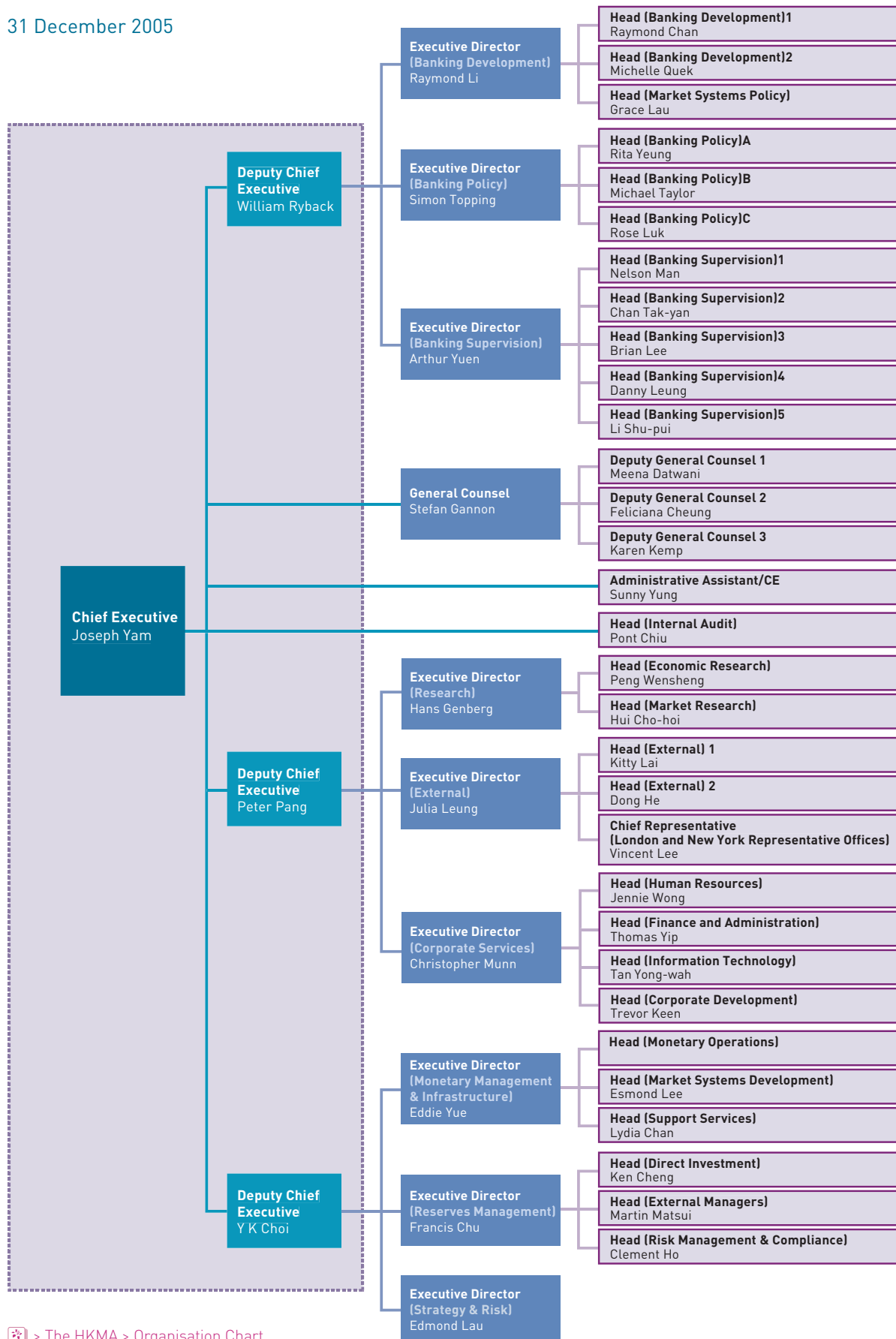
**CHIEF EXECUTIVE OFFICER
(HONG KONG MORTGAGE
CORPORATION)**

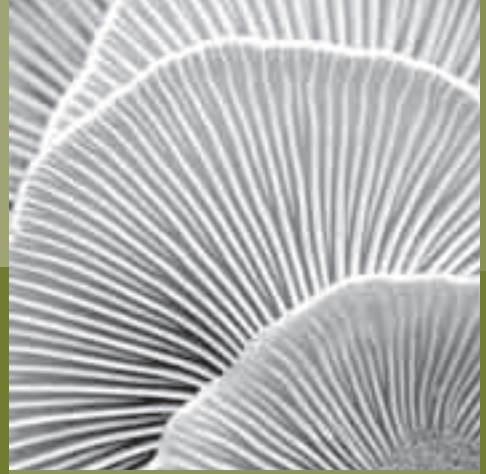
James H LAU Jr, JP

James Lau has been the Chief Executive Officer of the Hong Kong Mortgage Corporation since July 2004. Mr Lau joined the HKMA in 1993 and became Executive Director (External) in 1994 and Executive Director (Monetary Management and Infrastructure) in 2000. Mr Lau joined the Hong Kong Government as an Administrative Officer in 1979. He was Hong Kong's Deputy Permanent Representative to the GATT in Geneva from 1986 to 1990 before joining the Office of the Exchange Fund as Assistant Director (Monetary Management) in 1991.

HKMA ORGANISATION CHART

31 December 2005





ECONOMIC AND BANKING ENVIRONMENT

Hong Kong's economy showed remarkable growth in 2005, continuing the robust and broad-based recovery the previous year. The buoyant domestic economy helped improve the operating environment of retail banks enabling them to record healthy profit growth.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy registered an impressive performance in 2005, following a strong and broad-based recovery in 2004. Real GDP grew by 7.3% in 2005, compared with a rise of 8.6% in 2004. Export earnings remained vibrant, aided by solid growth among Hong Kong's major trading partners. Despite higher interest rates and a moderation in the property market, private consumer and investment spending increased further (Table 1). Consumer price inflation remained benign, notwithstanding a moderate rise during the year. The unemployment rate fell steadily, although it remained high by historical standards.

Monetary conditions tightened during the year, reflecting rises in local interest rates and a real appreciation of the Hong Kong dollar. Broad money growth picked up notably alongside robust economic expansion. Narrow money declined, partly owing to a shift away from liquid monetary assets to term deposits.

Robust domestic demand

Private domestic demand remained robust, but the growth rate slowed somewhat from that in 2004 due to higher interest rates and a moderation in the property market. Helped by improved labour market conditions and household income, private consumption rose by 3.7% in 2005, compared with a rise of 7.3% in 2004.

Table 1. GDP by components (percentage change over a year ago in real terms)

	2004					2005				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private consumption expenditure	6.5	11.2	5.7	6.0	7.3	4.2	2.7	4.1	3.7	3.7
Government consumption expenditure	5.6	0.0	-1.3	-1.7	0.7	-4.6	-2.3	-1.6	-3.4	-3.0
Gross domestic fixed capital formation	4.4	10.3	0.8	-2.4	3.0	0.4	4.9	2.8	7.5	3.9
Change in inventories ¹	1.9	2.4	-0.2	-4.2	-0.2	-4.2	-3.3	0.9	2.7	-0.8
Net exports of goods ¹	-2.8	-3.4	1.2	7.4	0.9	6.5	5.5	2.5	-0.7	3.3
Net exports of services ¹	3.6	4.4	2.7	1.8	3.1	1.8	2.6	2.2	2.3	2.2
GDP	8.1	12.4	6.8	7.5	8.6	6.0	7.3	8.3	7.6	7.3

¹ Percentage-point contribution to annual growth of GDP.

Source: Census and Statistics Department.

Private investment spending grew by 7.6%, following an increase of 5.1% in 2004. Growth in expenditure on machinery, equipment and computer software picked up slightly, while the rate of decline in spending on building and construction slowed. The decline in public spending expanded to 6.8%, reflecting the Government's cost-saving efforts, the scaling down of the Public Housing Programme and the completion of several large railway projects (Chart 1).

Outstanding export performance

Exports of goods and services increased distinctly in 2005, bolstered by robust global growth and strong expansion in the Mainland's external trade. Exports of goods recorded the third consecutive year of double-digit growth of 11.2%, following an increase of 15.3% in 2004. Among Hong Kong's major markets, exports to the Mainland, the European Union and Japan continued to increase notably, while growth in exports to some Asian economies moderated (Table 2). Exports of services rose by 8.4%, driven mainly by buoyant trade-related services, although

Chart 1. Domestic demand



Source: Census and Statistics Department.

Table 2. Merchandise exports by major trading partners¹

	Share	2004					2005				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	45	16	22	23	17	20	12	15	14	14	14
United States	16	4	6	4	7	5	6	7	8	2	6
European Union	15	12	18	20	22	18	17	18	16	13	16
Japan	5	10	17	14	16	14	12	12	13	6	10
ASEAN5 ² + Korea	7	24	23	17	13	19	6	8	6	9	7
Taiwan	2	20	25	14	7	16	-3	4	7	3	3
Others	10	10	14	16	17	15	11	9	15	5	10
Total	100	13	18	17	15	16	11	12	13	10	11

¹ Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.
² ASEAN5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand.

Source: Census and Statistics Department.

growth in exports of travel-related services slowed markedly to 7.3% from 19.2% in 2004. However, the strong growth in 2004 in part reflected a rebound from the severe disruption caused by the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2003. The overall trade surplus widened from 12.1% of GDP in 2004 to 16.4% in 2005, reflecting a decline in the merchandise trade deficit and an increase in the service trade surplus (Chart 2).

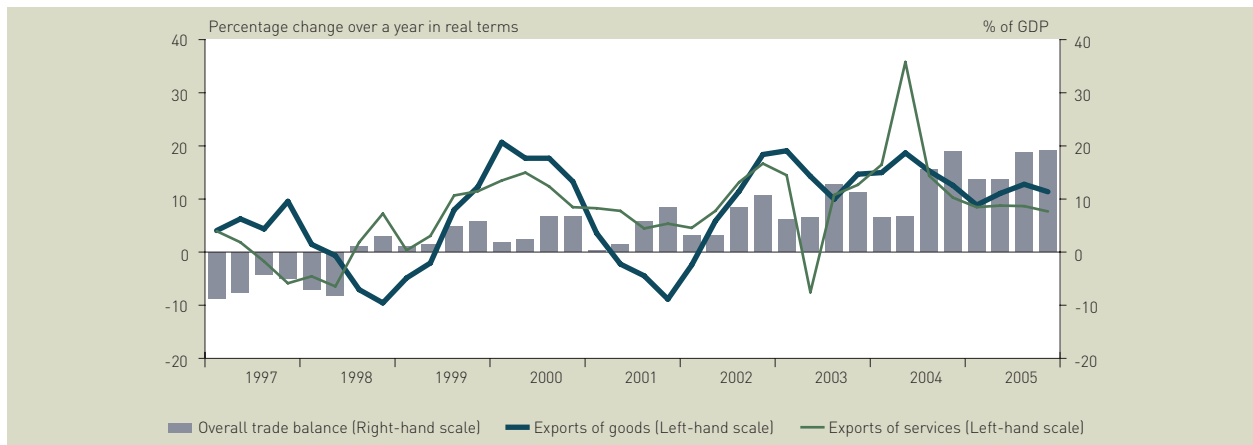
Return of inflation

Consumer price inflation edged up steadily during 2005 because aggregate demand continued to pick up and increases in residential rents started to feed through into the consumer price index. Nevertheless, overall

inflationary pressure remained benign. The year-on-year change in the Composite Consumer Price Index (CCPI) increased from -0.5% in January to 1.8% in December and averaged 1.1% for 2005 as a whole, following a mild decline of 0.4% in 2004. This was the first annual increase in seven years.

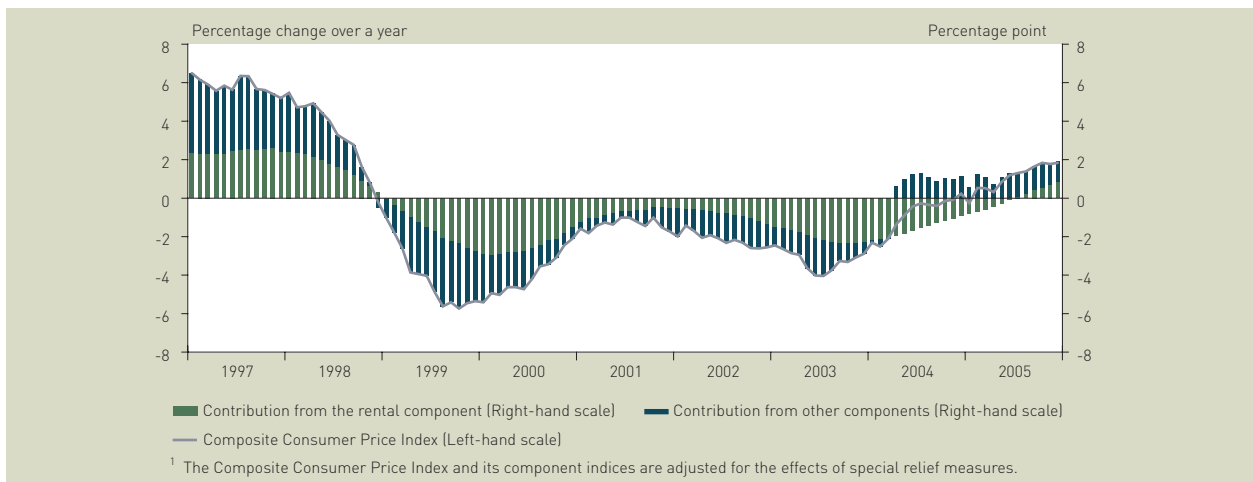
The pick-up in the year-on-year inflation rate occurred across most major components in the CCPI. In particular, the rental component rose markedly from -3.5% in January to 3.5% in December, contributing almost half of the increase in the overall CCPI in the final month of 2005 (Chart 3). Reflecting Hong Kong's high service orientation and low oil intensity, energy price increases had little effect on overall inflation.

Chart 2. Overall trade balance and export growth



Source: Census and Statistics Department.

Chart 3. Consumer prices¹



¹ The Composite Consumer Price Index and its component indices are adjusted for the effects of special relief measures.

Source: Census and Statistics Department and staff estimates.

Improved labour market conditions

The sustained economic recovery further boosted labour demand, which helped to bring the unemployment rate down to a four-year low of 5.3% in the final quarter of 2005, from a historic high of 8.6% in mid-2003. However, the effect of employment growth on the unemployment rate was partly offset by a rise in the labour force. The relatively stable participation rate suggests that the increase in the labour force was due largely to an expansion in the working-age population (Chart 4).

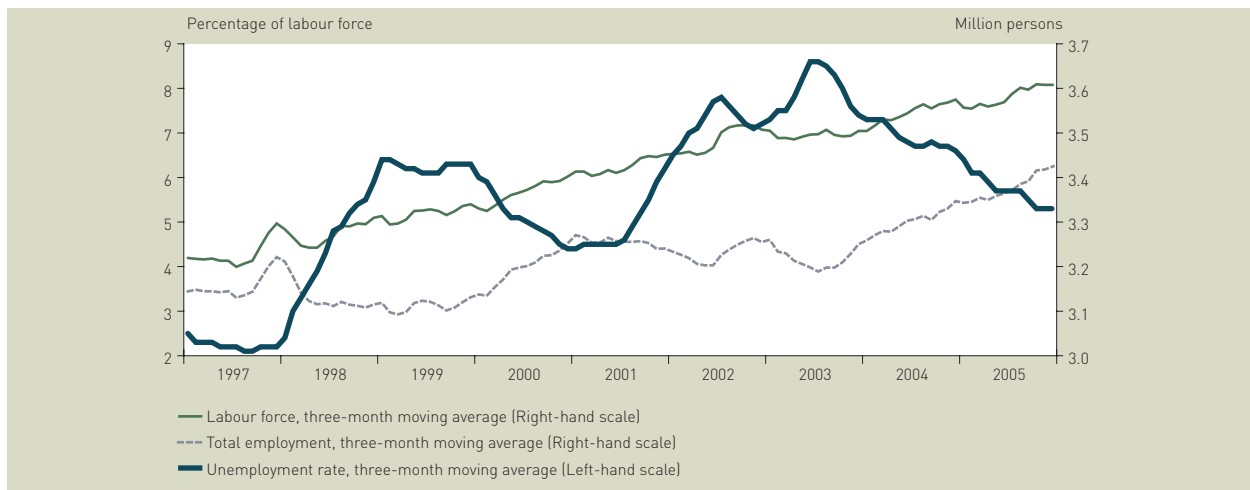
Increased labour demand has led to rises in labour earnings. The nominal payroll per worker, which includes remuneration, overtime payments, back-pay, and other irregular allowances and bonuses, increased

by 3.5% in the first three quarters of 2005 over a year earlier, compared with a decline of 0.7% in 2004. The increase was particularly strong in the retail, trade, hotel and transport sectors.

Sustained recovery in asset markets

The property market continued to recover in the first quarter of 2005. However, increases in interest rates since March have had some dampening effect on market activities, as indicated by a moderation in prices and transaction volumes. Despite a decline in the latter part of 2005, private residential property prices increased moderately by 6.7% in December from a year ago, following a sharp increase of 27.4% in 2004. Prices of private office also rose by 16.6% while prices of retail space fell by 0.8% during 2005. The number of Sale and

Chart 4. Labour market conditions



Source: Census and Statistics Department.

Purchase Agreements dropped markedly by 32.4% in the second half of the year compared with the first half. Nevertheless, the total number of transactions in 2005 was the highest since 1997.

Local stock prices recorded significant fluctuations during the year, affected by volatile capital flows and energy prices, and expectations of rising interest rates. Following six months of range trading, the Hang Seng Index soared to a four-and-a-half-year high in the third quarter. The rally was driven by a number of factors including better-than-expected corporate interim reports and the revaluation of the renminbi. Owing to renewed concerns about an extension of the interest-rate-hike cycle in the US, the Hang Seng Index fell markedly in October before recovering part of the loss in the last two months of the year. The index recorded its third straight year of increase, closing at 14,876 or 4.5% higher than its level at the end of 2004.

MONETARY CONDITIONS

Monetary conditions tightened in 2005 as a result of rising local interest rates and a real appreciation of the Hong Kong dollar. From June 2004 to the end of 2005, the US federal funds target rate was raised 13 times by a total of 325 basis points. Hong Kong dollar interest rates largely stayed low in the first few months of 2005 due to continued capital inflow, but started to catch up with the US rates from May. On a trade-weighted basis, the Hong Kong dollar appreciated in real terms during 2005, reflecting a broad-based strengthening of the US dollar and moderate inflation.

Narrow money and broad money growth diverged

Hong Kong dollar narrow money fell by 15.6% during the year, while broad money expanded by 5.7%. The divergence of narrow and broad money growth reflected in part a shift from liquid monetary assets to term deposits. The decline in narrow money occurred in response to the increased opportunity cost of holding non-interest bearing monetary assets. Strong growth in time deposits, which was mainly associated with the recovery of the economy and higher deposit rates, accounted for a significant part of the increase in broad money.

Notes and coins

At the end of 2005, the total value of banknotes in circulation was \$149,295 million, an increase of 1.7% from a year ago (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation amounted to \$6,482 million, an increase of 5.9% from a year ago (Charts 8 and 9). The value of \$10 notes in circulation reached \$1,447 million, an increase of 28% from 2004.

Chart 5. Banknotes in circulation by note-issuing banks at the end of 2005

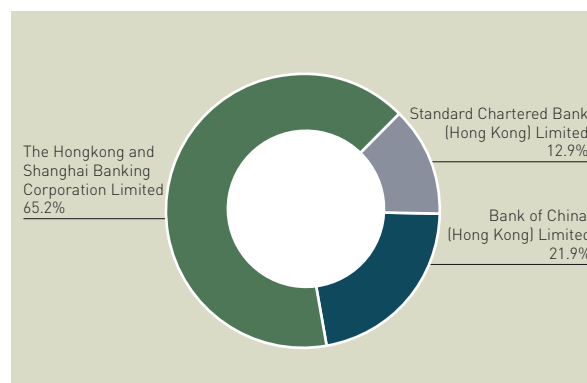


Chart 6. Banknotes in circulation at the end of 2005

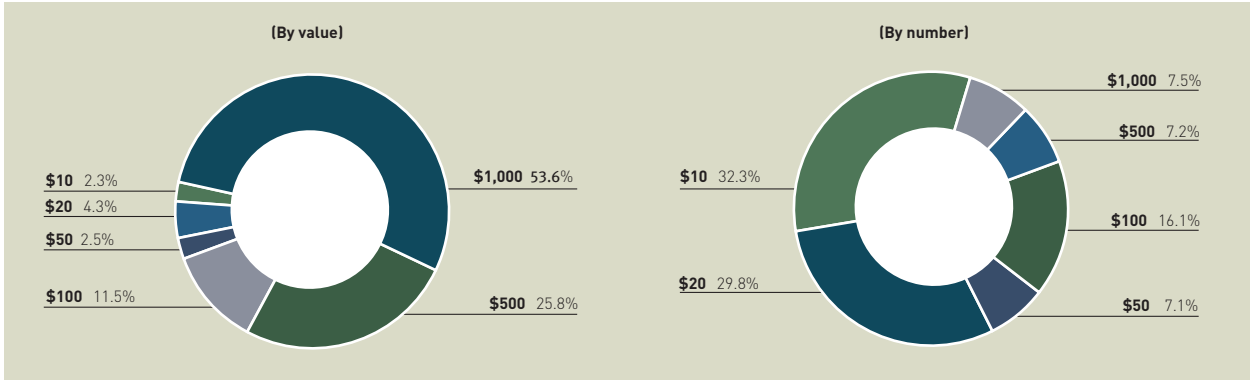


Chart 7. Banknotes in circulation at end of year

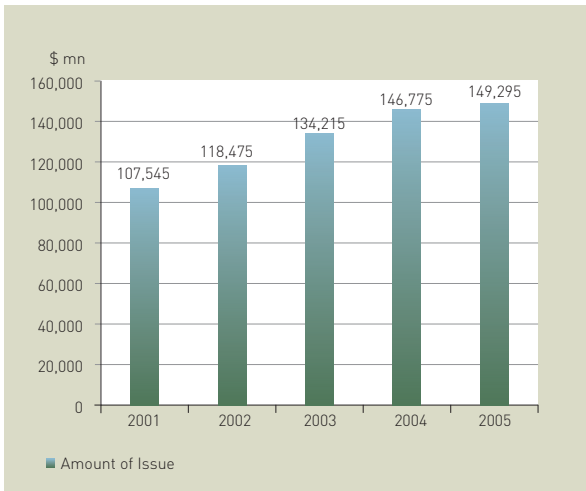
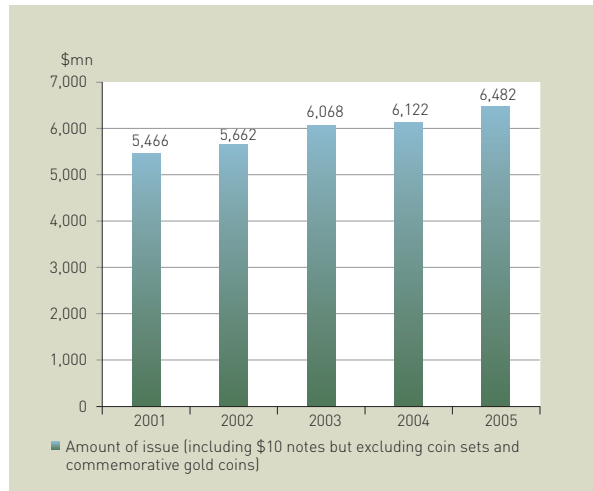


Chart 8. Government-issued notes and coins in circulation at end of year



New Hong Kong banknotes

The new series banknotes issued in 2003/2004 received favourable public response. Additional security features are incorporated in the series to combat counterfeiting.

 > [Consumer Information](#) > [New Hong Kong Banknotes](#)

To promote public awareness of the designs and security features of the new banknotes, 33 seminars were organised in 2005 for about 3,200 bank tellers, retail cashiers, moneychangers and cash-handling staff of chain stores and hotels. Participants found the seminars useful in providing them with knowledge and skills for

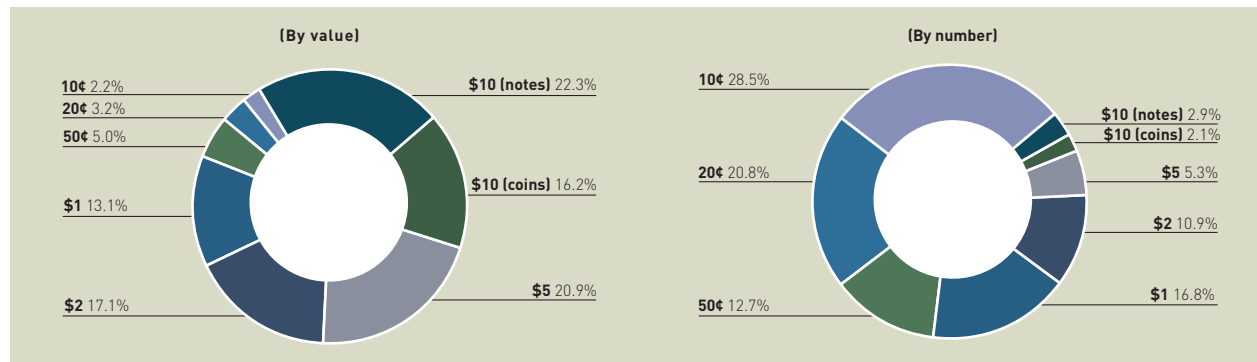
authenticating banknotes. In promoting conservation and a more cost-effective cash management system, the HKMA worked with the three note-issuing banks to encourage members of the public to use “good-as-new notes” for lai-see money instead of using only brand new notes. Talk shows on TV were organised to emphasise this message as well as promoting the security features of banknotes.

Coin replacement programme

The programme to withdraw coins bearing the Queen’s Head design continued throughout the year. In 2005, 27 million coins were removed from circulation.

 > [Consumer Information](#) > [Notes and Coins](#)

Chart 9. Government-issued notes and coins in circulation at the end of 2005



OUTLOOK FOR THE ECONOMY

Economic growth to continue

Economic growth in 2006 is expected to remain solid, but the pace of expansion is likely to moderate. The expected slowdown reflects mainly higher interest rates and possible slower growth in some of Hong Kong's main trading partners. Higher interest rates will raise funding costs and debt-service burdens, and dampen consumer and business sentiments, while slower global growth will affect external demand. However, the Hong Kong economy will continue to be supported by some positive factors. First, the third phase of the Closer Economic Partnership Arrangement (CEPA III) between Hong Kong and the Mainland, which comes into effect on 1 January 2006, should benefit Hong Kong's domestic exports and exports of financial and business services. CEPA III covers all Hong Kong products under the tariff exemption scheme and further relaxes the market access conditions for some local service suppliers. Secondly, the opening of Hong Kong Disneyland in September 2005 and the further broadening of the Individual Visit Scheme to include more provinces and cities on the Mainland should support growth in tourism-related sectors. Finally, the continuing improvement in labour market conditions should help consumer spending.

Inflation to increase and labour market conditions to improve

Inflation is expected to pick up modestly in 2006, reflecting a continuous increase in aggregate demand and a further pass-through of rises in residential rents to the consumer price index. In addition, rising rents for commercial properties, especially retail space, will exert upward pressure on firms' operating costs. External factors, such as high oil prices and the appreciation of the renminbi, could also feed into higher import prices. However, the risk of a substantial increase in inflation remains low, largely reflecting the generally benign core inflation in Hong Kong's major trading partners.

Labour market conditions are expected to improve further in 2006. Employment should continue to expand along with the increase in economic activity, although the pace of expansion may moderate. The unemployment rate is expected to decline further.

Uncertainties and risks

The generally positive economic prospects are subject to a number of uncertainties and risks arising from both external and domestic developments. The main external uncertainties include sustained high and volatile oil prices, larger-than-expected interest rate rises in the major economies, and macroeconomic and financial conditions on the Mainland. The rise in oil prices in the past few years has had limited impact on global growth. However, if high oil prices persist or rise further, the impact on the global economy could be larger. In particular, a stronger feeding through to core inflation may trigger more aggressive monetary tightening by major central banks than anticipated. The terms of trade shock arising from high oil prices could also worsen the global imbalance and risk sharp adjustments in exchange rates and interest rates. Under the Linked Exchange Rate system, interest rates in Hong Kong generally move in tandem with those in the US. A marked rise in interest rates will hurt asset markets and, in turn, private consumption and investment through the wealth and balance-sheet effects.

Developments in the Mainland economy will continue to have an important bearing on Hong Kong. Growing trade protectionism in the US and Europe against the Mainland and pressure on the renminbi exchange rate are of particular concern. Although the recent bilateral trade agreements on textiles that the Mainland signed with the European Union and the US represent significant progress in reducing trade tensions between the countries, trade protectionist sentiments against the Mainland's exports remain. A slowdown in the Mainland's export growth due to more intense protectionism could

affect Hong Kong's export performance. At the same time, Hong Kong will be affected by movements in the renminbi exchange rate through its trade and financial links with the Mainland. Locally, increases in interest rates and the associated dampening effect on the property market raise concerns about the durability of domestic demand growth. Finally, there is the risk of an avian flu pandemic, which represents a shock that has a potentially major effect on the economy.

 > Publications > Half-Yearly Monetary and Financial Stability Report

 > Statistics

PERFORMANCE OF THE BANKING SECTOR

The banking sector performed well in 2005 as the buoyant domestic economy helped improve the operating environment. The industry enjoyed healthy growth in operating income on the back of sustained loan growth, improved margins, and the release of surplus provisions due to continued improvement in asset quality. Healthy loan growth and improved interest margins combined to permit the first increase in net interest income since 2001. Non-interest income, particularly in areas of treasury operations and retail and private banking, also boosted profitability.

The recovery in net interest margins started after the introduction of the refinements to the Linked Exchange Rate system in May 2005, which ended a period of exceptionally high liquidity in the banking system. Following these refinements, interbank liquidity returned to more normal levels and Hong Kong money market rates adjusted accordingly. As a result, interest rates in Hong Kong began to mirror the tightening path that the US Federal Reserve had been taking, and banks began a series of increases in their best lending rates to reach 7.75% to 8.00% by the end of the year.

In addition to good profitability and asset quality, the banking sector also maintained high levels of capital and liquidity. The favourable indicators suggest that the banking system is well placed to support continuing economic recovery.

Interest rate trends

Interbank and deposit rates increased

The shrinking of excessive interbank liquidity after the introduction of the refinements to the Linked Exchange Rate system in the middle of 2005 allowed Hong Kong money market rates and deposit rates to increase. One-month HIBOR rose to an annual average rate of 2.91% from 0.30% in 2004 and the one-month time deposit rate rose to 1.26% from 0.03% (Table 3). Banks responded to higher funding costs by raising their best lending rates in increments from 5.00% in May to 7.75% or 8.00% in December. As a result, the spread between the annual

Table 3. Hong Kong dollar interest rate movements (period-average figures)

% per annum	Time deposits			HIBOR			Savings deposits	Best lending rate*
	1-month	3-month	12-month	1-month	3-month	12-month		
Q1-2005	0.12	0.17	0.61	1.28	1.50	2.12	0.04	5.03
Q2-2005	0.83	0.90	1.32	2.72	2.80	3.12	0.59	5.47
Q3-2005	1.65	1.74	2.12	3.53	3.68	3.93	1.25	6.58
Q4-2005	2.45	2.60	2.85	4.10	4.26	4.56	1.98	7.37
2004	0.03	0.04	0.26	0.30	0.46	1.19	0.02	5.02
2005	1.26	1.35	1.72	2.91	3.06	3.44	0.97	6.11

* Best lending rate refers to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

average best lending rate and the annual average one-month HIBOR narrowed to 320 basis points compared with 472 basis points in 2004. The spread between the average best lending rate and the one-month time deposit rate contracted to 485 basis points from 499 basis points.

Profitability trends

Retail banks continued to record healthy profit growth in 2005, benefiting from the buoyant domestic economy. The aggregate pre-tax operating profits of the retail banks' Hong Kong offices increased by 8.2%, continuing the strong post-SARS rebound in profitability in 2004 (Chart 10). The post-tax return on average assets also rose to 1.40% from 1.39%^r (Chart 11).

Chart 10. Retail banks' year-on-year growth of operating profit before tax

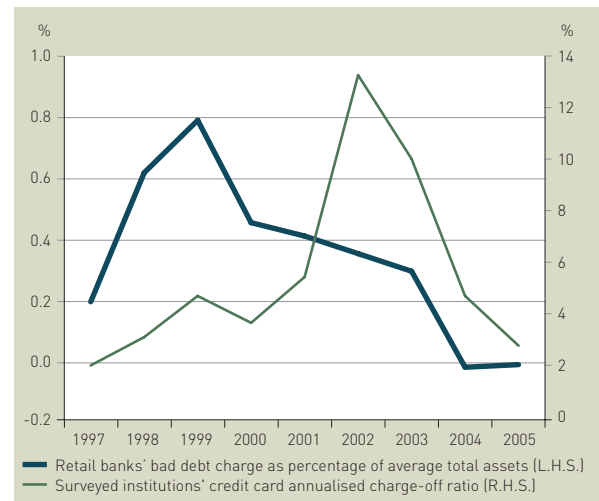


Chart 11. Retail banks' return on assets (after-tax profit)



Both net interest income and non-interest income (mainly income from treasury operations and fees and commissions) contributed to the healthy growth in profits. The proportion of retail banks' non-interest income to total income increased to 40.9% from 39.3% in 2004, while the share of income from treasury operations remained broadly unchanged at 20%. Provision write-backs continued to contribute to profitability, reflecting a continuing improvement in asset quality, although some banks began to make net new provisions in the second half of the year. Overall, retail banks' ratio of bad debt charge to average total assets stood at -0.01% compared with -0.02% in 2004 (Chart 12).

Chart 12. Charge-off ratios



^r Figure revised.

For the first time in three years retail banks experienced an increase in net interest income. The increase was attributable to improved lending margins, particularly in residential mortgages, and higher yield on free funds. Although the net interest margin was under pressure in the first half of the year due to excessive liquidity, retail banks' net interest margin increased to 1.68% from 1.66%^r in 2004 on the back of an expansion in interest-bearing assets and improvement in lending margins in the second half of the year (Chart 13).

Retail banks' operating costs continued to increase in 2005. This was largely due to the rise in staff expenses resulting from additional recruitment for business expansion and pay rises. As a result, retail banks' cost-to-income ratio rose to 41.9% from 41.4%^r in 2004 (Chart 14).

Chart 13. Retail banks' net interest margin

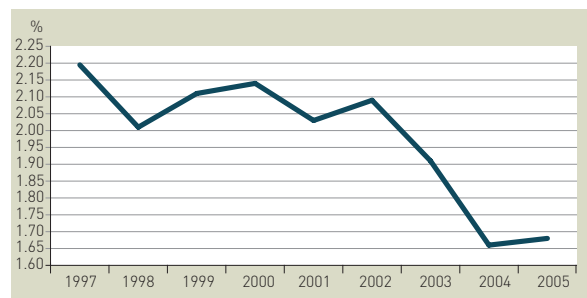
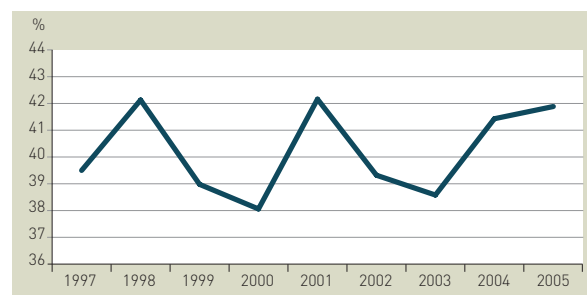


Chart 14. Retail banks' cost-to-income ratio



^r Figure revised.

Balance sheet trends

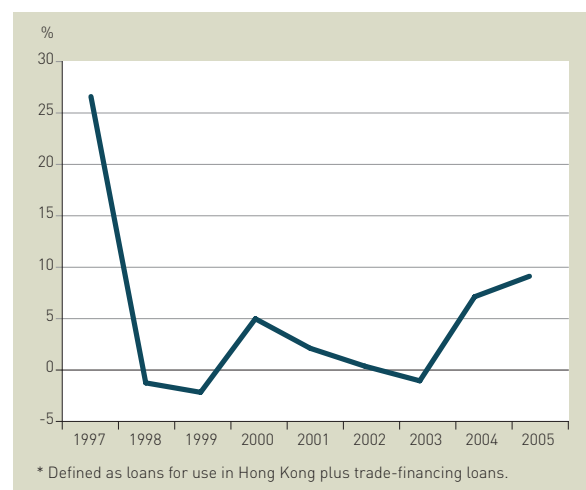
Driven by the buoyant domestic economy, total assets of the banking sector and the retail banks expanded by 1.5% and 3.4% respectively. Retail banks' deposit liabilities also increased by 3.1%. The increase was larger in the fourth quarter as higher deposit rates attracted more funds.

Growth in domestic loan demand

Benefiting from the robust domestic economy and growth in external trade, retail banks' total lending rose by 9.8% in 2005. Domestic lending, mainly property lending and trade financing, increased by 9.2% (Chart 15), compared with 7.2% in 2004. Reflecting broad-based economic growth, lending to all major economic sectors increased. Loans for use outside Hong Kong also increased considerably by 27.1%.

Property lending rose by 7.6% after an increase of 5.7% in 2004. Loans for property investment and residential mortgages increased by 17.1% and 2.1% respectively compared with 16.0% and 2.9% in 2004. Loans for property development reversed a decline of 3.8% in 2004 to grow by 13.8%.

Chart 15. Retail banks' year-on-year growth of loans to customers inside Hong Kong*



Helped by strong external trade growth, trade financing rose by 10.7% compared with 17.6% in 2004. Loans to the manufacturing sector also rose by 16.4% after the post-SARS rebound of 29.6% in 2004. As the number of Mainland visitors continued to increase and consumption demand continued to grow, lending to the wholesale and retail trade sector grew by 5.8%. Amid the buoyant stock market activity, the decline in loans to stockbrokers slowed to 0.1% from 30.4% in 2004. Loans to non-stock-broking companies and individuals for purchasing shares rose further by 42.4% following an increase of 11.9% in 2004. Lending to the information technology sector also rose by 12.7%, with much of the increase attributable to lending to the telecommunication sector, which grew by 22.8% after having fallen for two consecutive years.

Better labour market conditions and improving household income encouraged a further expansion in lending to individuals, particularly credit card lending. According to the regular survey of authorized institutions active in credit card business, total credit card receivables rose by 14.9% following an increase of 5.2% in 2004.

Total outstanding exposure to non-bank Chinese entities increased in 2005. The increase mainly reflected the increase in exposures to H-share companies and their subsidiaries and other entities known to be owned or controlled by Chinese interests. Retail banks' exposure increased by 10.0% to \$141.3 billion and accounted for 2.8% of their total assets. The exposure of the banking sector also increased to \$206.1 billion (2.6% of total assets).

Increased holding of negotiable debt instruments

As a result of improved lending opportunities, retail banks' holding of negotiable debt instruments (NDIs, excluding negotiable certificate of deposits (NCDs)) grew by a slower rate of 6.0% compared with 6.7% in 2004. The increase was largely attributable to corporate debt instruments denominated in foreign currencies. NDIs denominated in Hong Kong dollars edged down by 0.5%, while foreign currency NDIs rose by 9.6% (Chart 16). About 54.8% of the NDIs were issued by corporates, while 22.8% were issued by governments and 22.4% by banks (Chart 17). The share of total holdings of NDIs by the retail banks to their total assets was stable at about 22% at the end of 2005.

Chart 16. Negotiable debt instruments held by retail banks (currency breakdown)

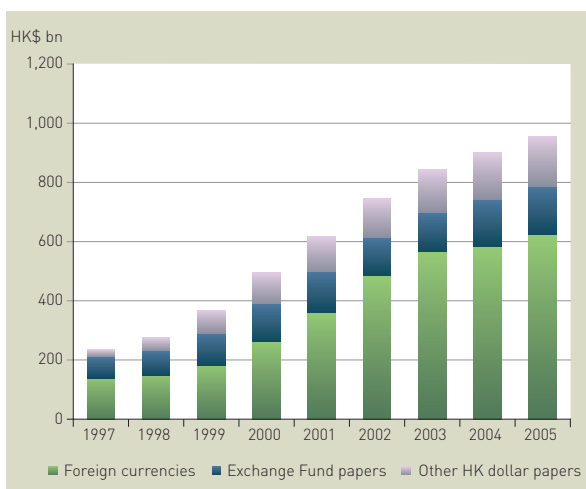
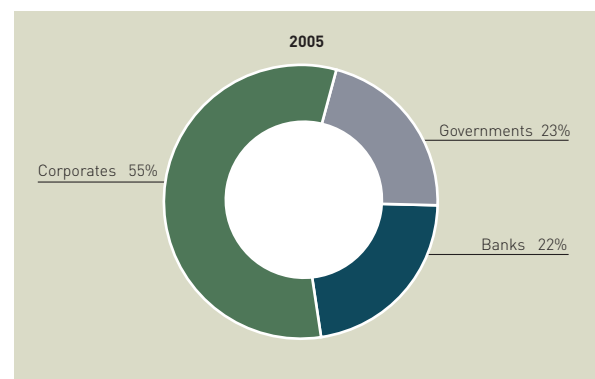


Chart 17. Negotiable debt instruments held by retail banks (counterparty breakdown)



Reflecting the continued demand for NCDs by retail customers, the outstanding amount of issued NCDs increased by 1.6% in 2005 after rising 10.4% in 2004. As holdings of NCDs by retail customers increased, the proportion of outstanding NCDs held by retail banks fell to 26.9% at the end of 2005, compared with 31.0% a year before.

Customer deposits expanded

Despite the outflow of funds following the introduction of the refinements to the Linked Exchange Rate system, retail banks' total customer deposits for the year as a whole expanded by 3.1%, after increasing 7.4% in 2004 (Chart 18). Much of the increase was recorded in the fourth quarter, especially in foreign currency deposits. With the 4.4% increase in foreign currency deposits outweighing the 2.2% increase in Hong Kong dollar deposits (Chart 19), the proportion of Hong Kong dollar deposits to total deposits decreased to 59% from 60% at the end of 2004. Attracted by the higher interest rates,

depositors shifted their savings and demand deposits to time deposits. This resulted in a sizeable increase in time deposits by 30.1% in 2005 compared with 1.1% in 2004. Savings and demand deposits fell by 21.2% and 17.0% respectively as opposed to an increase of 11.8% and 22.9% in 2004. At the end of 2005, savings and demand deposits together accounted for 41.1% of total deposits, down from 53.3% a year earlier.

Retail banks remained highly liquid

Retail banks remained highly liquid in 2005, although the industry's loan-to-deposit ratios in all currencies (2005: 53.2%; 2004: 50.0%) and in Hong Kong dollar (2005: 78.8%; 2004: 73.2%) increased as loans grew faster than deposits.

Chart 18. Retail banks' year-on-year growth of total customer deposits

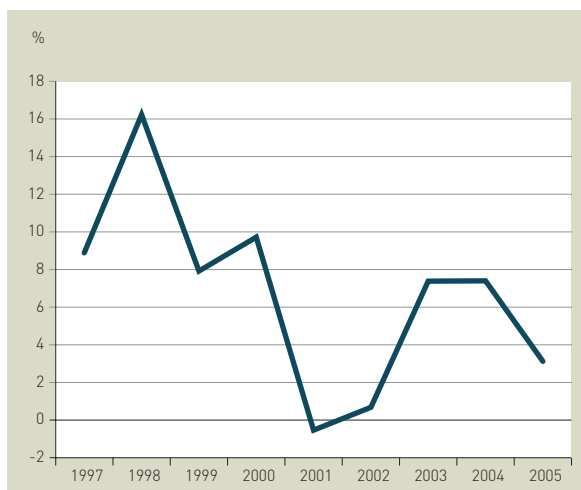


Chart 19. Retail banks' year-on-year growth of Hong Kong dollar deposits*

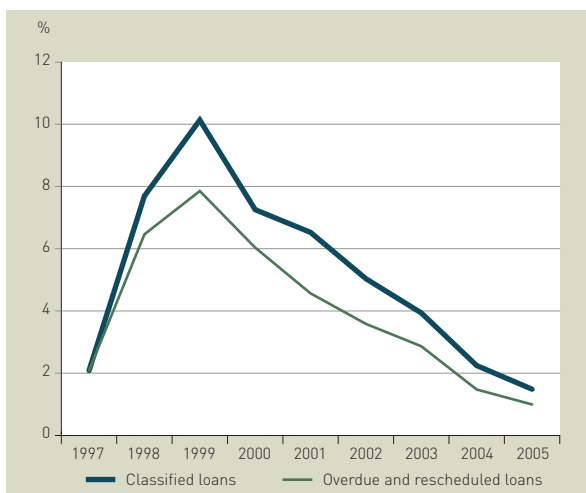


Improvement in overall asset quality continued

The overall asset quality of retail banks strengthened further in 2005 with the continued improvements in the domestic economy, the labour market, income levels and property values. All problem loan ratios of the retail banks declined from 2004. The ratio of loans overdue for more than three months dropped to 0.69% from 1.05%^r at the end of 2004. Together with a decrease in the rescheduled loan ratio to 0.23%, the combined ratio of overdue and rescheduled loans improved to 0.92% from 1.48%. The classified loan ratio also declined to 1.38% from 2.25%^r at the end of 2004 (Chart 20).

The delinquency ratio of the residential mortgage portfolio fell to a new low of 0.19% at the end of 2005, reflecting the better labour market conditions and household income levels, both helped strengthen the repayment ability of homeowners (Chart 21). The rescheduled loan ratio also declined to 0.35% from 0.47%.

Chart 20. Retail banks' gross classified loans and combined overdue and rescheduled loans as a percentage of total loans



^r Figure revised.

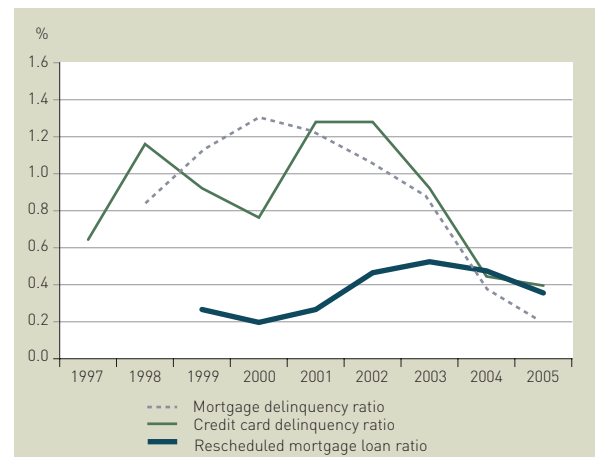
The outstanding number of residential mortgage loans in negative equity decreased by 43% from 2004 to stand at about 11,000 cases by the end of 2005. This was despite a slight increase in the number of cases in the fourth quarter as interest rate increases affected property valuations. Compared with the peak of 106,000 cases in June 2003, the number of negative equity cases was down by 90%.

The overall quality of credit card lending by the banks improved, with the credit card charge-off ratio for the year dipping to 2.81% from 4.73% in 2004 (Chart 12), and the credit card delinquency ratio declining to a new low of 0.37% from 0.44%. The improvements were also helped in part by the transfer of some rescheduled receivables outside the credit card portfolio. Taking into account the outstanding rescheduled credit card receivables, which amounted to \$60 million, or 0.1% of total receivables, the combined delinquent and rescheduled ratio fell to 0.45% at the end of the year.

 > Press Releases > Residential Mortgage Survey

 > Press Releases > Credit Card Lending Survey

Chart 21. Asset quality of credit card and mortgage lending by surveyed institutions



Strong capital ratio

With risk-weighted assets growing faster than capital base, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions declined slightly to 14.9% at the end of 2005, still well above the statutory minimum of 8% (Chart 22).

As a result of the increase in risk-weighted assets, the tier-one capital ratio also fell to 13.3% at the end of 2005, compared with 13.6%^f at the end of 2004 (Chart 22).

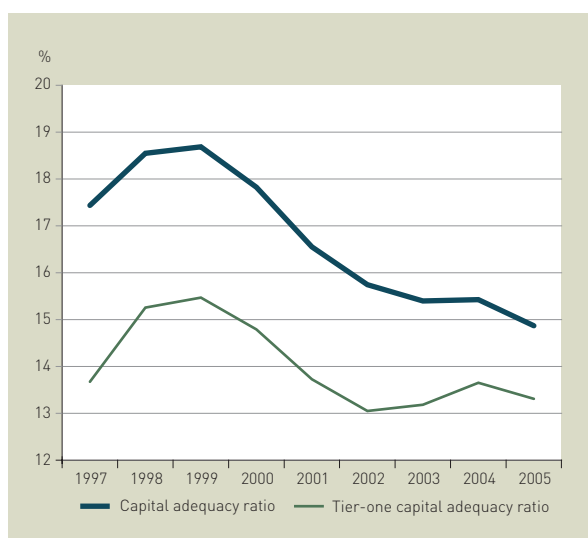
PROSPECTS FOR 2006

The strong financial condition of the banking system leaves it well placed to support the continuing economic recovery and to weather any future shocks. The greatest uncertainty for 2006 concerns the effect that the series of interest rate increases, which began in the second half of 2005, will have on loan demand and credit quality. There are early indications that the increased cost of borrowing has had some marginal impact on the demand for new loans, particularly in the residential mortgage market,

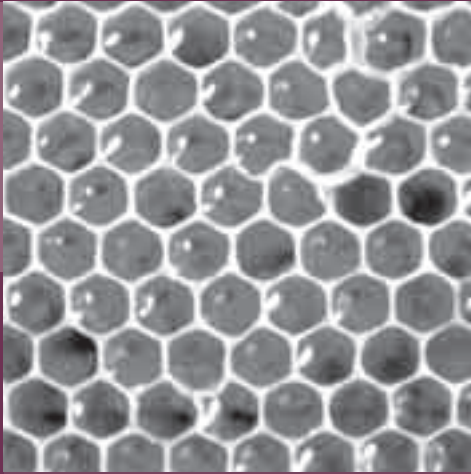
and there may have been some slight deterioration of loan quality towards the end of 2005. However, given that all indicators show asset qualities are good by historical experience, a slight deterioration of loan quality during 2006 is probably to be expected.

Although interest margins have recovered from the low point reached in the first half of 2005, they nonetheless remain low by historical standards. Highly competitive loan and deposit markets have contributed to the long-run tightening of margins and these conditions persist, notwithstanding the removal of the conditions of excessive liquidity seen in early 2005. Against this background, the key to sustained future profitability will be the continuing ability of banks to keep their operating and funding costs under control and to diversify their sources of income. These conditions are likely to favour large banks with their big retail deposit bases and their ability to diversify their income sources and product range. Smaller banks are likely to continue to find the conditions challenging.

Chart 22. Consolidated capital adequacy ratio of all locally incorporated AIs



^f Figure revised.



MONETARY STABILITY

Refinements to the operation of the Linked Exchange Rate system introduced in May 2005 removed the uncertainty about the strong-side potential of the Hong Kong dollar and made the interest rate adjustment mechanism more efficient.

OBJECTIVES

The primary monetary policy objective of Hong Kong is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, in terms of its exchange rate in the foreign exchange market against the US dollar, at around HK\$7.80 to US\$1. The structure of the monetary system is characterised by a Currency Board arrangement, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by, and changes in it to be 100 per cent matched by, corresponding changes in US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1.

The Monetary Base has four components:

- Certificates of Indebtedness, which provide backing on banknotes issued by the three note-issuing banks
- government-issued notes and coins in circulation
- the sum of the balances of the clearing accounts held by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, issued by the HKMA on behalf of the Government.

 > [Monetary Base](#)

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism. When there is a decrease in the demand for Hong Kong dollars and the market exchange rate weakens to the weak-side convertibility rate of HK\$7.85 per US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks. The Aggregate Balance (as part of the Monetary Base) will decrease, pushing up Hong Kong dollar interest rates to induce capital inflows to restore exchange rate stability. Conversely, if there is an increase in the demand for Hong Kong dollars and the market exchange rate strengthens to the strong-side convertibility rate of HK\$7.75 per US dollar, the HKMA will sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will expand, exerting downward pressure on Hong Kong dollar interest rates to restrain inflows.

 > [Monetary Stability](#) > [Currency Board System](#)

REVIEW OF 2005

The exchange and money markets were largely stable during the year. As appreciation pressures built up in late 2004 abated, the Hong Kong dollar exchange rate gradually weakened towards the Linked Rate of 7.8 in January 2005 (Chart 1). Thereafter, the Hong Kong dollar exchange rate stayed near the Linked Rate between February and April. The weak-side Convertibility Undertaking of 7.8 was triggered intermittently during this period, with the HKMA buying a total of \$12.0 billion

worth of Hong Kong dollars. The Hong Kong dollar exchange rate began to strengthen again in late April, due to speculation about a change in the renminbi exchange rate regime.

On May 18, the HKMA announced three refinements to the operation of the Linked Exchange Rate system to make interest rate and exchange rate adjustments more effective:

- (1) A strong-side Convertibility Undertaking was established, under which the HKMA undertakes to buy US dollars from licensed banks at 7.75.
- (2) The weak-side Convertibility Undertaking was gradually moved from 7.80 to 7.85 (by 100 pips per week from 23 May to 20 June) to create a symmetric Convertibility Zone around 7.80.
- (3) The HKMA may conduct market operations consistent with Currency Board principles within the Convertibility Zone.

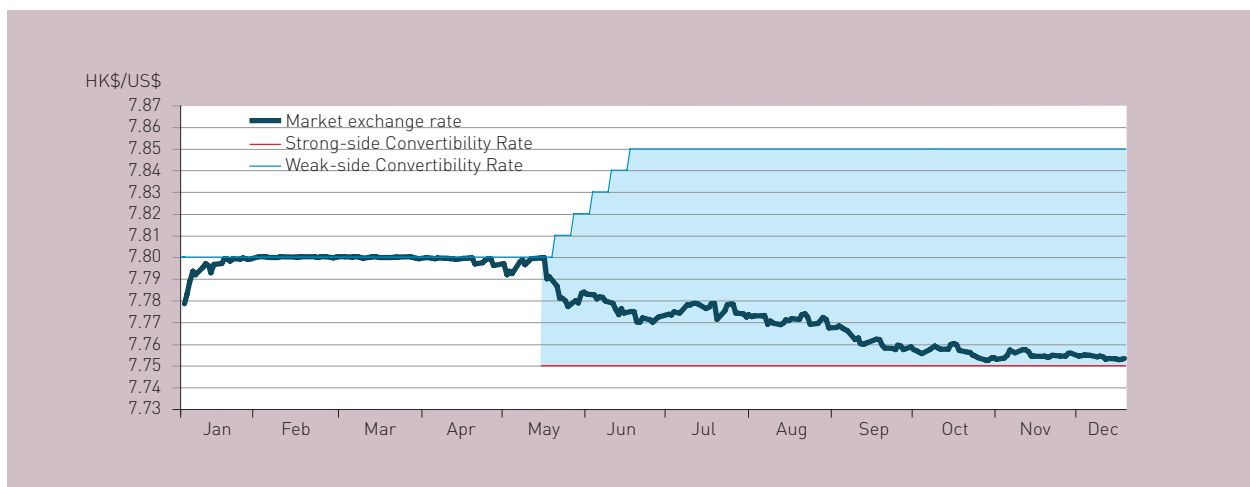
The refinements are aimed at removing uncertainty about the strong-side potential of the Hong Kong dollar. By anchoring exchange rate expectations on the strong

side, the measures should make the interest rate adjustment mechanism more effective and efficient. The initial reaction from the foreign exchange and money markets suggested that the refinements were effective. Immediately following the announcement, market expectations of an appreciation of the Hong Kong dollar diminished and the weak-side Convertibility Undertaking of 7.8 was triggered, prompting the HKMA to buy \$3.12 billion Hong Kong dollars from banks.

On 21 July, the People's Bank of China announced reforms to the renminbi exchange rate system by moving to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The Hong Kong dollar exchange rate responded calmly to the announcement, suggesting that the three refinements are effective in anchoring exchange rate expectations on the strong side.

Under the Currency Board arrangements, foreign exchange operations of the HKMA lead to corresponding changes in the Aggregate Balance. The weak-side Convertibility Undertaking of 7.8 was occasionally activated between January and April 2005, decreasing the Aggregate Balance from \$15.8 billion to \$3.9 billion

Chart 1. Market exchange rate, January – December 2005



(Chart 2). Following the introduction of the refinements to the Linked Exchange Rate system, the weak-side Convertibility Undertaking was triggered and the Aggregate Balance shrank to \$714 million on 20 May. Subsequently, to address a rising demand for Hong Kong dollars in anticipation of a number of equity initial public offerings, the HKMA conducted market operations within the Convertibility Zone on 25 May, selling \$544 million Hong Kong dollars to banks. As a result, the Aggregate Balance increased to \$1.32 billion on 27 May. The HKMA did not conduct any further market operations and the Aggregate Balance remained stable at around \$1.3 billion for the remainder of the year, with small fluctuations due to interest payments on Exchange Fund paper.

The Hong Kong dollar forward discount narrowed markedly during the year (Chart 3). The 12-month forward discount fluctuated between 400 and 1,600 pips (each pip equivalent to HK\$0.0001) before the introduction of the Linked Exchange Rate refinements, but narrowed markedly afterwards to around 250 pips at the end of the year. This reflected dissipated market expectations of appreciation of the Hong Kong dollar after the introduction of the three refinements.

Hong Kong dollar interbank interest rates rose significantly during the year. This reflected tightened interbank liquidity following repeated triggering of the weak-side Convertibility Undertaking in the early part of 2005, the introduction of the three refinements to the

Chart 2. Aggregate Balance, January – December 2005

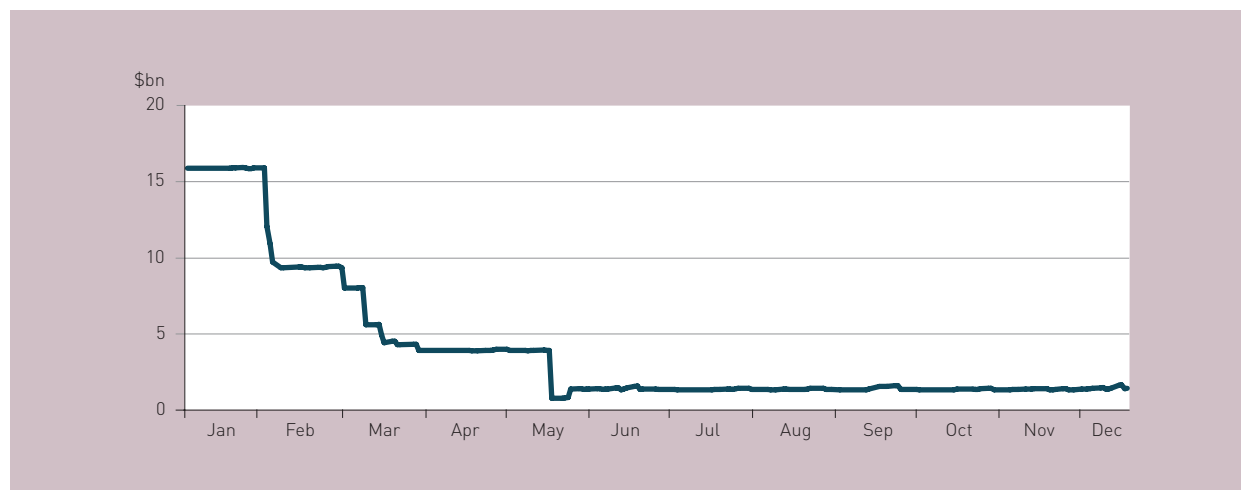
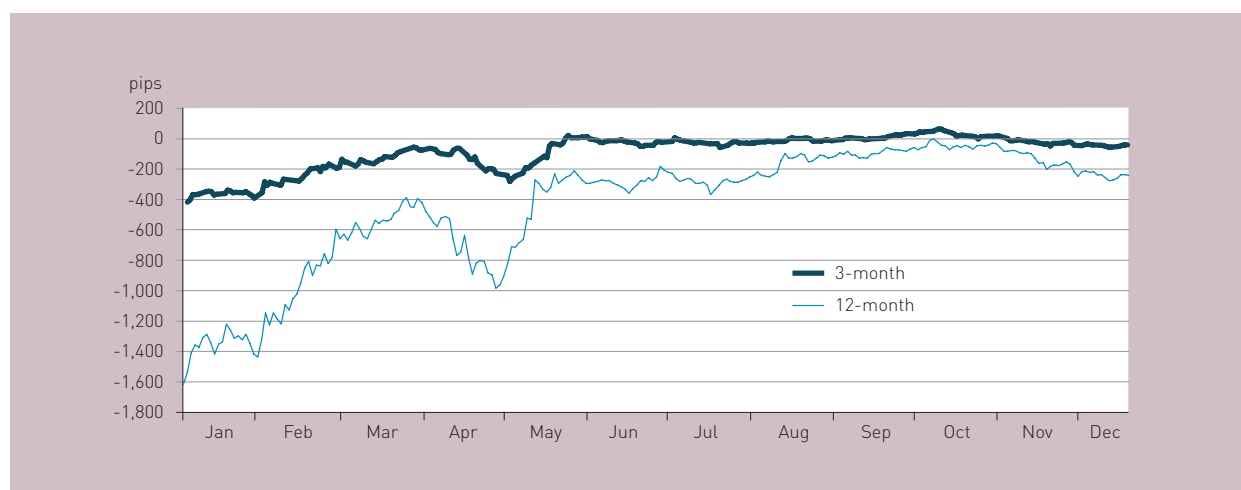


Chart 3. Hong Kong dollar forward points, January – December 2005



Linked Exchange Rate system, and increases in the US federal funds target rate throughout the year (Chart 4). The first two factors also led to a rapid catch-up of Hong Kong dollar interbank rates with their US dollar counterparts, substantially narrowing the negative interest rate spreads (Chart 5). For the year as a whole, short-term interest rates rose by about 390 basis points, exceeding the increase of 200 basis points in the US federal funds target rate.

Interest rate volatility, measured by the standard deviation of daily changes in the one-month interbank rate, remained at low levels during the year. The Discount Window functioned smoothly to accommodate liquidity

shocks and overnight interbank interest rates rarely exceeded the Base Rate of the Discount Window.

A specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998 to improve the transparency of the Currency Board Account. The Backing Ratio, defined as the ratio of Backing Assets to the Monetary Base, rose from 111.05% at the beginning of 2005 to a high of 112.52% on 15 March, surpassing the Upper Trigger Level of 112.5% (Chart 6). This largely reflected the contraction in the Aggregate Balance as a result of the triggering of the weak-side Convertibility Undertaking in the early part of the year.¹ Under the arrangements approved by the

Chart 4. HIBORs, January – December 2005

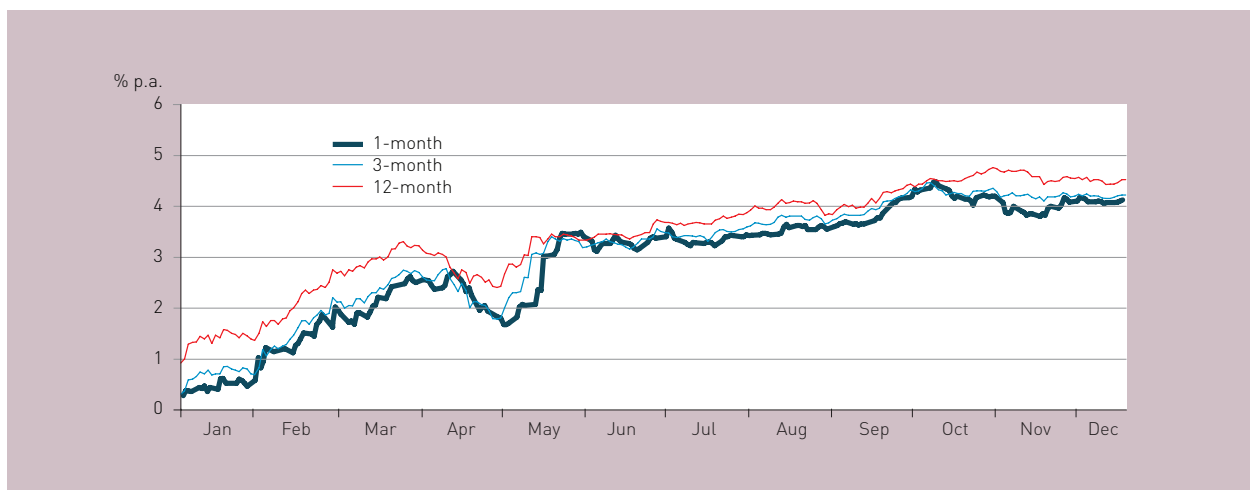
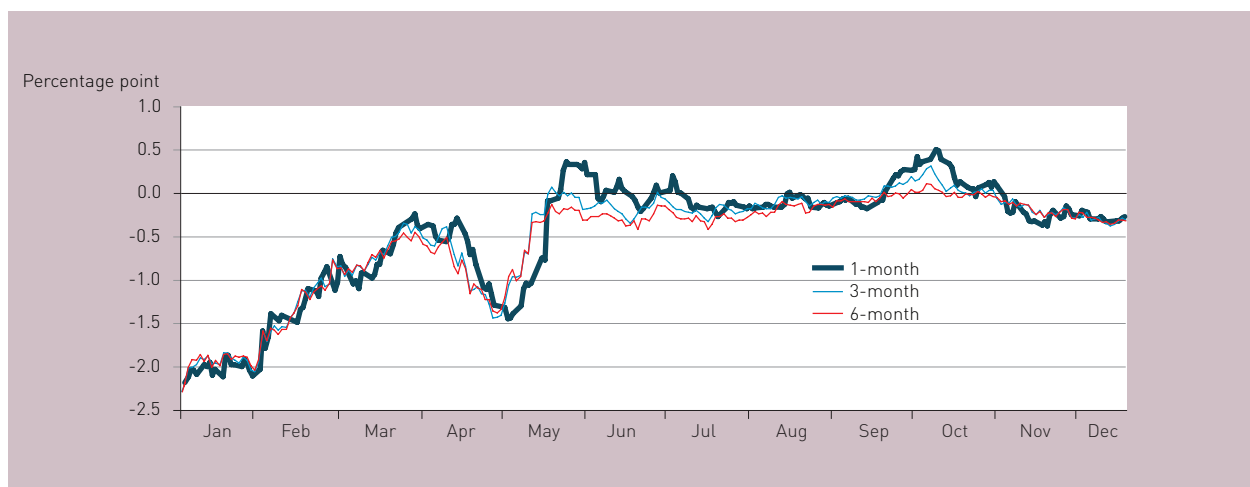


Chart 5. HK dollar – US dollar interest rate differentials, January – December 2005



¹ While the Backing Assets decreased by the same magnitude as the Monetary Base, the fractional decrease was smaller in the former because of its larger size, thus increasing the Backing Ratio.

Financial Secretary in January 2000, assets were transferred out of the Backing Portfolio to reduce the Backing Ratio to around 110% on 16 March. Thereafter, the Backing Ratio rose steadily to close at 111.67% at the end of the year.

Activities at the HKMA

The EFAC Currency Board Sub-Committee continued to review issues crucial to monetary and financial stability in Hong Kong. These issues included convertibility arrangements for the Aggregate Balance, implications of the new renminbi exchange rate regime for Hong Kong, external demand for Hong Kong dollar currency, money and inflation in Mainland China, and a monetary conditions index for the Mainland.

 > [Press Releases](#) > [Monetary Policy](#)

The Hong Kong Institute for Monetary Research, established in August 1999, has continued to sponsor research in the fields of monetary policy, banking and finance. In 2005, the Institute hosted 18 full-time and two part-time research fellows. It also published 22 working papers and one occasional paper.

 > [Research Memorandums](#)

The Institute co-hosted a roundtable meeting in October with the Representative Office for Asia and the Pacific of the Bank for International Settlements. The meeting reviewed the long-term prospects for regional monetary co-operation in Asia following the changes in the

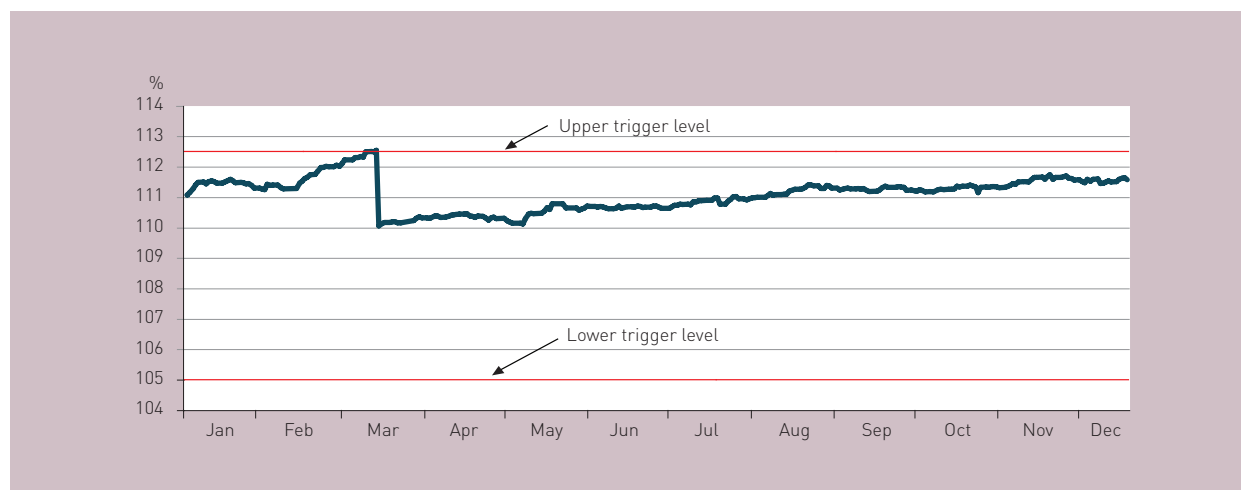
renminbi and Malaysian ringgit exchange rate regimes. Another function the Institute co-organised with the Representative Office was the *Monetary Policy Approaches and Implementation in Asia* conference in November with the participation of the region's central banks, academics, and officials from international financial institutions. In December, the Institute, together with the Centre for Central Banking Studies of the Bank of England, arranged a four-day workshop on financial stability and fragility with participants from seven central banks in the region. Other Institute programmes included a two-day workshop on the Mainland's property market and macro-economy in July and the Third Summer Workshop in September. In addition to conferences and workshops, 40 public seminars were organised during the year on a broad range of economic and monetary issues.

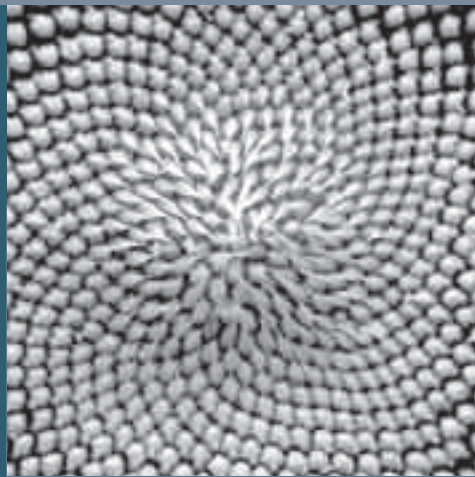
 > [Links](#) > [HKMA-related Organisations](#) > [Hong Kong Institute for Monetary Research](#)

PLANS FOR 2006 AND BEYOND

The HKMA will continue to examine various economic issues in its research programme for the coming year. The EFAC Currency Board Sub-Committee will closely monitor risks and vulnerabilities in the domestic and external environments that may affect Hong Kong's monetary and financial stability. The Sub-Committee will also keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them further.

Chart 6. Backing Ratio, January – December 2005





BANKING STABILITY

One of the main objectives of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking businesses and the supervision of authorized institutions. A major priority in 2005 was to ensure they had adequate policies and risk management procedures to combat money laundering and terrorist financing activities. On the policy front, the enactment of the Banking (Amendment) Ordinance 2005 helped to advance the necessary preparations for the implementation of Basel II.

OBJECTIVES

The responsibility for promoting the safety and soundness of the banking system is shared among three departments within the HKMA:

- the *Banking Supervision Department* handles the day-to-day supervision of authorized institutions (AIs)¹
- the *Banking Policy Department* formulates supervisory policies to promote the safety and soundness of the banking sector
- the *Banking Development Department* formulates policies to promote the development of the banking industry.

REVIEW OF 2005

Risk-based supervision

To ensure more effective implementation of the risk-based approach to banking supervision, the Banking Supervision Department was reorganised into five divisions focusing on large and complex institutions, foreign institutions, local institutions, China-related institutions and technical supervision. This has enabled the HKMA to utilise better its supervisory resources and more effectively develop expertise to identify and tackle different types of risk faced by the banking industry over the next few years. The reorganisation has resulted in cost savings, while allowing the upgrading of some posts to ensure that personnel of the right calibre are available to meet the increased challenges.

During 2005, the HKMA conducted a total of 228 on-site examinations, which included 92 risk-based and eight treasury examinations. The on-site examinations included 64 focused examinations: 18 to assess AIs' compliance with the restrictions on personal renminbi business, 24 on residential mortgage loans and 22 on trade-financing business. With AIs' continuing reliance on information technology and the increasing popularity of Internet banking services, the HKMA's specialised teams conducted 17 special examinations of Internet banking services and IT-related controls, and another 17 examinations of AIs' business continuity planning. The

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks and deposit-taking companies.

HKMA also carried out five tier-2² examinations of the securities business of AIs. In view of the growing demand for retail investment products, the HKMA conducted 14 focused examinations of AIs' retail wealth management operations, including a review of their policies and procedures on client-suitability assessment.

The HKMA carried out 14 more risk-based on-site examinations during 2005 than in 2004. As these risk-based examinations cover a wider scope of issues, they require more resources than focused examinations. As a result, the total number of on-site examinations declined.

The reorganisation of the Banking Supervision Department enabled slightly more off-site reviews and tripartite meetings (among the HKMA, an AI, and its external auditors) to be conducted in 2005 than in 2004. This was achieved despite resources being used to deal with ad hoc duties, such as approving bank mergers and restructuring and processing migration applications under the Securities and Futures Ordinance. A total of 187 off-site reviews and 71 tripartite meetings were held during the year.

The HKMA continued to maintain regular contacts with the boards of directors of locally incorporated AIs. These contacts help strengthen communication and improve understanding of the AIs' state of affairs, financial position and strategic direction. During the year, HKMA staff met the boards of four licensed banks and one restricted licence bank, and the board-level committees (in particular the audit committees) of 13 banks.

The Banking Supervision Review Committee considered seven cases relating to the licensing of AIs and the fitness and propriety of controllers. In addition, 332

applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2005 are shown in Table 1.

Table 1 Operational supervision

	2004	2005
1. On-site examinations	247	228
Including		
– risk-based	78	92
– treasury	11	8
– securities	7	5
– e-banking	24	17
– review of business continuity plan	17	17
– review of renminbi business	36	18
– overseas examinations	20	11
– retail wealth management	–	14
– trade financing	–	22
– residential mortgage	17	24
2. Off-site reviews and prudential interviews	183	187
3. Tripartite meetings	66	71
4. Meetings with boards of directors or board-level committee of AIs	8	18
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	376	332
6. Reports commissioned under Section 59(2) of the Banking Ordinance	1	4
7. Cases considered by the Banking Supervision Review Committee	9	7

In 2005, the Monetary Authority used the powers under Section 59(2) of the Banking Ordinance to require four AIs to commission external auditors to review internal control issues and report their findings to the HKMA.

During the year, no AI breached the Banking Ordinance relating to the capital adequacy ratio, liquidity ratio and the large exposures under Section 81. There were three breaches of the requirements relating to connected lending under Section 83. These breaches, which were technical and unintentional in nature, were promptly rectified and they did not affect the interests of depositors or creditors.

² Tier-1 examinations are high-level examinations which assess the adequacy of AIs' general management controls over the areas being examined. Tier-2 examinations are more in-depth and focused assessments, including detailed testing and verification as warranted by the risks involved, of the effectiveness of the AIs' relevant controls.

CAMEL³ rating review

In the second half of 2005, the CAMEL Approval Committee met on a number of occasions to consider the CAMEL ratings of all licensed banks and most restricted licence banks and deposit-taking companies. As all licensed banks are members of the Deposit Protection Scheme, it was necessary to provide their CAMEL ratings (relating to their positions on 20 October 2005) to the Hong Kong Deposit Protection Board before the end of the year. The banks involved were given an opportunity to request a review of their ratings. Four banks requested such a review, and meetings of the independent CAMEL Approval Review Committee formed by members not involved in the original rating decisions were convened to consider the requests.

Appointment of Manager

On the advice of the Financial Secretary, the Monetary Authority used the powers under Section 52(1) of the Banking Ordinance to appoint, on 16 September, a Manager to manage the affairs, business and property of Delta Asia Credit Limited (DAC), a deposit-taking company. The action was taken in the light of serious allegations made by an overseas authority relating to the parent bank of DAC in Macau. The assets of DAC were also ring-fenced. These steps were intended to protect the interests of DAC's depositors and to safeguard the integrity of the banking system. The HKMA has since been liaising closely with the relevant overseas authorities to monitor developments and assess the implications for DAC and its parent bank.

Focused examinations

Treasury activities

The growing involvement of the banking sector in dealing with complex structured products and the uncertainties surrounding interest rate movements have increased the risks faced by Als' treasury operations. Through the redeployment of internal resources, the HKMA has set up a second treasury examination team to monitor and examine the effectiveness of Als' systems for managing their interest rate risk and the risks arising from transactions involving complex structured and derivatives products. The main duty of the second team is to benchmark relevant risk management practices and, where appropriate, develop a set of best practices on critical treasury functions that Als are encouraged to follow. In December, the HKMA discussed with Als involved in derivatives and structured products the need to examine the latest market trends and risk-management practices. This has helped the HKMA to set its supervisory priorities for 2006.

Wealth management activities

Driven by the narrowing return from lending activities and investor demand for more comprehensive financial products and services, banks in Hong Kong have become increasingly active in offering wealth management products to retail customers. In 2005, the HKMA conducted on-site examinations of the retail wealth management business of 14 Als, focusing on their compliance with the relevant Code of Conduct, including risk disclosure and customer suitability checking. The overall findings indicated that banks generally had effective procedures to ensure compliance with the requirements. Nevertheless, a number of banks have identified ways to improve their client suitability procedures.

³ An internationally recognised framework for assessing the quality of banks based on **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity.

Residential mortgage and trade financing business

In view of the growing trend in early 2005 for AIs to use large cash rebates to compete for new residential mortgage business, the HKMA issued a circular in February setting out the treatment of these rebates for residential mortgage business within the context of the 70% loan-to-value ratio guideline. The circular stated that cash rebates exceeding 1% of the residential mortgage loan amount should be treated as part of the loan amount for the purpose of calculating the loan-to-value ratio, and that any cash rebate offered by a developer, directly or indirectly, should be deducted from the purchase price before determining the value of the property concerned.

The HKMA also carried out focused examinations on the residential mortgage business of 25 AIs to assess their compliance with the 70% guideline, their risk-management systems, underwriting criteria and business practices. During these residential mortgage loan examinations, the HKMA took the opportunity to examine 21 AIs' procedures for preventing and detecting trade financing fraud and controls over the use of trade finance facilities. The results indicated that the AIs concerned had satisfactory controls and risk management systems.

Securities business

In addition to on-site securities examinations, the HKMA implemented an automated compliance self-assessment process to cover 30 AIs that are active in securities business. The outcome of the assessment will help the HKMA to improve its supervisory effectiveness. It will also foster a culture of compliance reviews among AIs. The outcome of the first assessment highlighted some control and compliance issues requiring remedial action, which is expected to be completed by the end of March 2006.

Internet banking services, IT-controls & business continuity planning

The HKMA conducted 34 on-site examinations of Internet banking, technology-risk management and business continuity planning. To help AIs better plan their resources for managing technology-related risk, the HKMA has shared the common findings from these on-site examinations with the Hong Kong Association of Banks (HKAB). The HKMA also extended the coverage of the automated control self-assessment process for Internet banking, technology-risk management and business continuity planning from 50 to 54 AIs. The results of the self-assessments indicated a marked improvement in the overall information technology control environment of AIs since self-assessment began in 2003.

Prevention of money laundering and terrorist financing

The revised *Supplement to the Guideline on Prevention of Money Laundering* took effect on 31 December 2004. The HKMA conducted 62 anti-money laundering examinations as part of its risk-based on-site examinations in 2005. To help AIs better understand common anti-money laundering issues and prioritise their resources for managing their reputation risk, the HKMA shared with HKAB the findings and observations from these examinations. The areas identified for further improvement by some AIs, include

- regular updates of anti-money laundering policies and procedures to incorporate the HKMA's latest requirements
- more effective monitoring of the activities of high-risk accounts and timely reporting of suspicious transactions to the relevant authorities
- continuing training of staff to maintain a high level of awareness and vigilance in the prevention of money laundering and terrorist financing.

In November, the HKMA issued a circular to the industry reiterating and clarifying the supervisory standards and approach towards combating money laundering and terrorist financing activities. AIs were reminded of the potential legal and reputation risks involved.

Safeguarding customer information

The leak of credit card data in the US in June had the potential to affect some 12,000 credit cards issued by AIs in Hong Kong. The AIs concerned promptly arranged to replace these cards before the end of July. The incident resulted in no financial loss for holders of cards issued by AIs. However, the HKMA took steps to minimise the chance of such an incident happening in Hong Kong. All

AIs were requested to re-assess and submit a formal report on the adequacy and effectiveness of controls over customer data security, retention and confidentiality (covering the AIs and their service providers). The overall results were satisfactory.

As the US incident involved inadequate security controls of a third-party service provider, the HKMA also conducted three special on-site examinations in October and November focusing on the controls over data input and the management of processes outsourced to service providers in Singapore and Mainland China.

Personal renminbi business

Personal renminbi business recorded significant growth in Hong Kong in 2005. Total deposits stood at RMB22.6 billion yuan at the end of the year, an increase of 86% from 2004.

The development of this business entered a new phase in November with the People's Bank of China announcing the expansion of the scope of the clearing arrangements. Participating banks in Hong Kong can benefit from the change by providing renminbi exchange and remittance services with increased transaction limits. They can also determine, on their own, the credit limit on renminbi credit cards, and take renminbi deposits from designated merchants, the definition of which has been expanded to cover more business categories. Banks can also begin offering renminbi current accounts to individual customers after the requisite system development is completed by Hong Kong Interbank Clearing Limited.

The HKMA conducted on-site examinations of the personal renminbi business of 18 banks, as opposed to examining all participating banks in 2004 when the business was first introduced. In 2005, a risk-based approach was adopted, which showed that the compliance of banks with the business restrictions was

satisfactory. Nevertheless, there was room for improvement in the internal systems of some banks to guard against non-compliance with the relevant business restrictions and detect irregular transactions. These banks were required to improve promptly their systems and controls.

As the business expands, the HKMA will continue to supervise closely personal renminbi business activities in 2006 through on-site examinations and a revised prudential return to collect more information from banks.

CEPA

Since its introduction in January 2004, the Closer Economic Partnership Arrangement has helped promote the expansion of Hong Kong-incorporated banks in Mainland China. The arrangement was further revised in October 2005, and subsequently refined in January 2006. Under CEPA III, the level of operating funds required of Mainland branches of Hong Kong-incorporated banks offering renminbi and foreign currency businesses to local customers is assessed on the basis of all the Mainland branches of a bank rather than each individual branch. Where the average level of operating funds of all Mainland branches is over RMB400 million yuan per branch, the operating funds allocated to an individual branch can be lowered to RMB300 million yuan. Through CEPA, eight Hong Kong-incorporated banks have become eligible to establish branches on the Mainland. Among these, five banks had opened six new Mainland branches by the end of 2005.

Non-bank China exposures

The HKMA considers it prudent to gather more comprehensive data on Als' aggregate exposures to Mainland China borrowers with the ever-increasing economic integration between Hong Kong and the

Mainland. After consultations with the industry, the HKMA introduced in December 2005 a revised reporting framework for non-bank China exposures. The major change is the new requirement to capture exposures to non-Mainland Chinese entities where the credit is for use on the Mainland. The revised reporting framework will take effect in the third quarter of 2006, with the first reporting to cover the position at the end of September 2006.

Supervision of technology and operational risks

Two-factor authentication for Internet banking

Two-factor authentication for high-risk transactions conducted through Internet banking in Hong Kong was launched on 30 May at a joint press conference held by the HKMA, HKAB and the Hong Kong Police Force. Hong Kong is one of the first jurisdictions among developed financial markets to establish this regulatory requirement, which contributes to the safety of Internet banking. The HKMA, together with the banking industry and the Police, launched a consumer education programme in late May to promote public awareness of the new system. By the end of the year, 21 Als had introduced two-factor authentication and around 940,000 customers (a 276% increase from mid-2005) had registered for the service.

The major retail banks have worked with IT vendors and customers to ensure that two-factor authentication can cater for the needs of the visually impaired. A number of solutions have been identified, including security tokens with voice output and one-time passwords delivered through a dedicated phone-banking hotline. The banks plan to test and implement the proposed solutions in the first half of 2006.

 > [Consumer Information](#) > [Internet Banking Safety](#)

Business continuity planning

The HKMA undertook a number of initiatives during the year to help the banking industry to address potential risks posed by mass demonstrations and cyber attacks when the World Trade Organization Sixth Ministerial Conference was held in Hong Kong in December. The HKMA, the Government's Co-ordination Office and the Police held a joint briefing session for the banking industry in September to discuss the anticipated disruptions during the Conference period and the recommended measures to address such incidents. The HKMA also issued a circular to AIs in October on the recommended measures regarding event management and business continuity planning around the time of the Conference. To effectively monitor and manage potential problems, the HKMA established an Event Management Centre at its office and required AIs to submit periodic status reports during the conference. Apart from the

temporary closure of some bank branches and ATM services due to nearby demonstrations, no major disruptions were reported by AIs. The smooth operation of the Centre confirmed that there is an effective and secure communication framework between the HKMA and all AIs, which will provide a solid foundation for handling future emergencies.

The HKMA invited the Department of Health to brief the banking industry on 7 November 2005 on precautions against a possible influenza pandemic. Some 250 participants from over 130 AIs attended the briefing. The HKMA also issued a circular to all AIs in November setting out recommended measures. An industry task force has been established by the HKMA and HKAB to monitor developments and review applicable business continuity practices for the banking sector.

Supervision of ancillary activities

Securities business

The HKMA continued to maintain close supervisory co-operation with the Securities and Futures Commission (SFC). Two bilateral meetings were held in 2005 to discuss matters related to the supervision of AIs' securities activities, in addition to the normal communication on day-to-day supervisory matters. To draw the attention of registered institutions (RIs) to important regulatory requirements and recommended practices, the HKMA issued a number of circulars, including

- a circular in February to recommend a number of control measures to help ensure proper registration of securities staff and maintenance of these individuals' particulars in the HKMA register
- a circular in March to draw the attention of RIs to the findings and regulatory requirements set out in the SFC's *Report on Selling Practices of Licensed Investment Advisers*

- a circular in November to remind AIs of the relevant supervisory requirements for ensuring the smooth operation of the subscription and refund processes of the initial public offer of the Link REIT.

Under the transitional arrangements of the Securities and Futures Ordinance, 74 AIs with deemed registration status (deemed RIs) lodged their migration applications before the expiry of the transitional period on 31 March 2005. By the end of 2005, the HKMA had completed assessment of the majority of the applications, resulting in 53 deemed RIs being registered with the SFC and two having revoked their status as AIs (and thus deemed RIs).

During the year, the HKMA granted consent to 172 executive officers, who are responsible for supervising the securities activities of RIs.

 > [HKMA Register of Securities Staff of Authorized Institutions](#)

In response to the recommendation of the Working Group on the Business Environment of the Stockbroking

Industry, the HKMA presented a proposal for discussion with the SFC on the revision of fees for Als' regulated activities under the Securities and Futures Ordinance. The intention is to replace the current flat fee rate with a sliding-scale fee structure.

Sections 58A and 71C of the Banking Ordinance have been amended to improve the securities regulatory regime by empowering the Monetary Authority to disclose relevant details of disciplinary action taken against securities staff of Als. Procedural improvements have also been made in the light of experience gained in administering the enforcement regime. Necessary steps are also being taken to increase the resources of the Securities Enforcement Team to handle the rising number of investigation cases and reported incidents with potential for disciplinary action.

During the year, investigations continued into 16 cases opened in 2003-2004. Another 10 cases were opened for investigation by the Event Review Committee, which is responsible for deciding whether to open cases for disciplinary investigation. At the end of 2005, the investigation of 17 cases was in progress and will continue into 2006.

The Disciplinary Committee, which is responsible for making recommendations on the exercise of disciplinary powers, considered nine cases on the completion of the investigations. Among these, one case involved short-selling, but no disciplinary action was taken under the Banking Ordinance as the individual concerned had left the banking industry to join the securities sector. Nevertheless, the individual was disciplined by the SFC. In another case concerning suspected malpractice of a former "relevant individual" of a registered institution when selling investment products, the individual had also left the banking industry and Hong Kong. Again, disciplinary action under the Ordinance could not be taken, although the person was put on a watch list designed to alert the HKMA's authorization team and other relevant licensing authorities should the individual apply again to perform regulated activities, whether in registered institutions or in licensed corporations.

Another case considered by the Disciplinary Committee involved the supervisory failure of a "relevant individual" that occurred prior to the commencement of the Securities and Futures Ordinance when the person was with his former employer. The investigation concluded there were insufficient grounds to find the individual not fit and proper under the new securities regime. The case was closed, but a warning letter was issued to the person concerned.

The other six cases were closed as there were insufficient grounds for disciplinary action. The cases included suspected lack of due care and diligence in order taking, suspected contravention of an honesty and fairness provision of the SFC's Code of Conduct, suspected failings in internal control systems, and suspected involvement in an overseas dealing malpractice.

Insurance and Mandatory Provident Fund businesses

The HKMA and the Insurance Authority held the second bilateral meeting in July to discuss current and evolving supervisory issues in the insurance activities of Als, and streamlined the procedures for handling insurance-related complaints received by the HKMA from bank customers. To improve the supervision of Als' insurance activities, the HKMA continued to collect half-yearly returns and conduct on-site examinations of Als active in insurance business.

The HKMA also worked with the Mandatory Provident Fund Schemes Authority, the SFC and the Insurance Authority on the revision of MPF intermediaries' registration and reporting requirements, which became effective on 1 October 2005. The changes included substituting MPF certificates for MPF cards, waiving the return of expired MPF cards and certificates to the MPFA, aligning the registration expiry dates of individual intermediaries with their sponsoring corporate intermediaries and stipulating compliance with the Continuing Professional Development requirement as a criterion in assessing the fitness and propriety of applicants and registrants.

Development of the banking sector infrastructure

The HKMA continued to provide assistance to the Hong Kong Deposit Protection Board in preparing for the launch of the Deposit Protection Scheme and to the banking industry for the further development of the Commercial Credit Reference Agency (CCRA).

(a) Deposit Protection Scheme

The Board is making good progress towards the launch of the Deposit Protection Scheme. The draft rules and guidelines governing the operation of the Scheme have been substantially completed after consultations with the industry associations and other interested parties. The payout system for assessing and paying compensation to depositors has been developed and is now undergoing a user acceptance test. Other preparatory tasks including the development of the payout policy and procedures and the engagement of professionals such as accounting and IT firms to assist the Board when a payout occurs are also close to completion.

(b) Commercial Credit Reference Agency

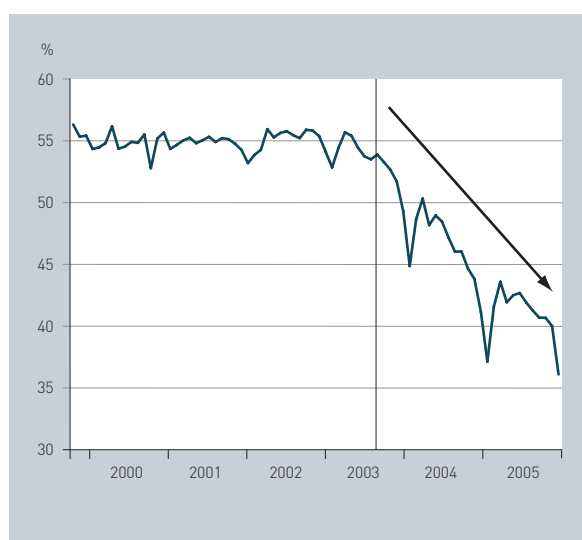
The Agency has been operating smoothly since its inception in November 2004. The scheme currently covers credit data of over 39,000 small and medium-sized enterprises defined as non-listed limited companies with an annual turnover not exceeding \$50 million. Over 120 AIs are sharing commercial credit data through the CCRA.

The Industry Working Group on the CCRA has considered different ways to expand the scheme's coverage to include sole proprietorships and partnerships. It has agreed in principle to follow the Code of Practice on Consumer Credit Data in sharing the credit data of sole proprietorships and partnerships. Detailed arrangements are being worked out.

Consumer credit data sharing

Using a set of indicators agreed with the Consumer Council, the HKMA conducted the first review of the benefits of positive credit data sharing. This followed the expiry, in June 2005, of the two-year moratorium on access to credit data for the purpose of credit review. The review showed clear benefits to both financial institutions and consumers. Specifically, the average indebtedness of bankrupts had declined from over 35 times their monthly income in June 2003 to 25 times in August 2005. This shows that with positive data sharing it is now more difficult for borrowers on the verge of bankruptcy to accumulate unreasonably large amounts of debt. Financial institutions also have better tools to avoid lending to these borrowers. After the introduction of positive data sharing, a significant amount of credit card rollover balances was substituted by lower-cost credit such as instalment loans and revolving credit facilities (Chart 1). This resulted in substantial interest savings on the part of consumers. Market practitioners believe this development might not have been possible without positive data sharing. Now the moratorium is over, it is expected financial institutions will make fuller use of positive data in their credit assessments, which could further benefit consumers.

Chart 1. Rollover ratio of credit card receivables



Source: HKMA.

During the year, AIs conducted a self-assessment of compliance with SPM IC-6, one of the modules in the *Supervisory Policy Manual*, which sets out the minimum standards that should be observed by AIs in sharing and using consumer credit data. The assessment results showed that participating AIs had further improved their systems to safeguard customer data privacy.

Consumer protection

Code of Banking Practice

The banking industry has completed the annual self-assessment of compliance with the Code of Banking Practice covering the period from June 2004 to May 2005. A total of 177 AIs providing personal banking services conducted the self-assessment, 151 of which reported full compliance with the Code. The rest of the AIs had five or fewer instances of non-compliance. The main area of non-compliance related to the terms and conditions of banking services. In a separate review conducted in early 2005, 98 AIs' terms and conditions of banking services (other than safe deposit box services) were found to contain exemption of liability clauses which were inconsistent with the Code. As for systems of control for monitoring compliance with the Code, all AIs reported they had adequate internal procedures and management oversight to ensure compliance. New products were reviewed to ensure compliance with the Code before they were launched. The results of the review were broadly in line with the previous year.

 > [Consumer Information](#) > [Code of Banking Practice](#)

Customer complaints

In 2005, the HKMA received 328 complaints, compared with 383 the previous year (Chart 2). The decrease was due mainly to a reduction in the number of complaints relating to the practices of debt collection agencies (DCAs). This was in line with the continuing decline in the number of complaints received by AIs against the DCAs employed by them. According to the quarterly returns

submitted by AIs since March 2002, the number of DCA-related complaints received by AIs further declined to 171 in 2005 from 348 in 2004, indicating that AIs have been vigilant in monitoring the performance of their DCAs (Chart 3).

 > [Consumer Information](#) > [Complaints about Banks](#)

Chart 2. Complaints received by the HKMA

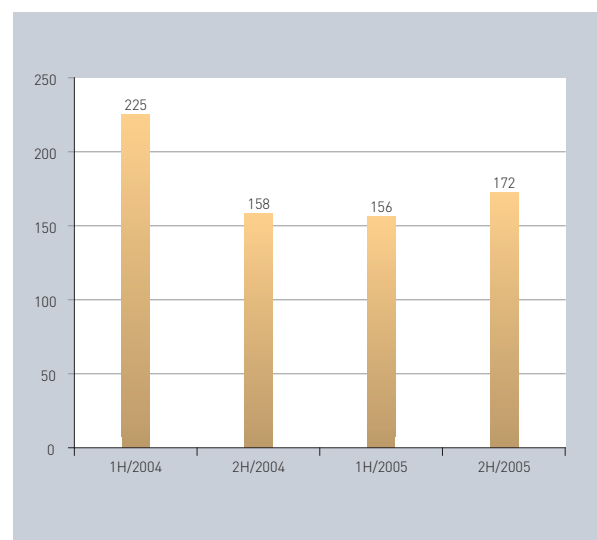
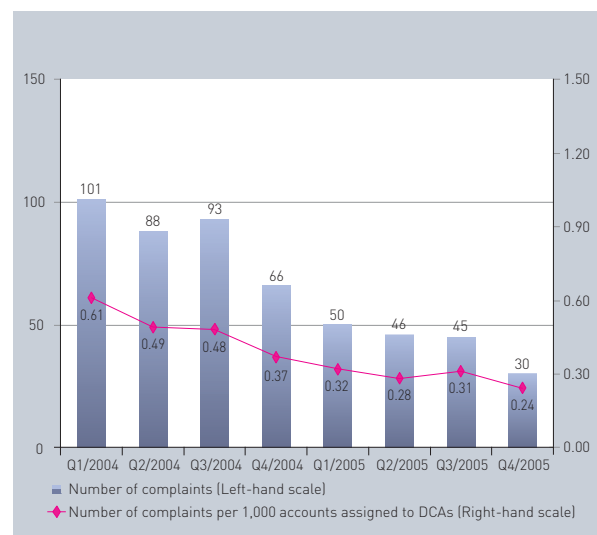


Chart 3. DCA complaints received by AIs



Basel II implementation

The HKMA, in consultation with the banking industry, continued to develop proposals and draft rules for implementing the revised capital adequacy standards under Basel II in Hong Kong in January 2007. The HKMA collaborated with the Department of Justice and the Financial Services and the Treasury Bureau to secure the passage of the Banking (Amendment) Bill 2005.

Banking (Amendment) Ordinance 2005

The Banking (Amendment) Ordinance 2005 was enacted on 6 July giving express statutory backing for the implementation of Basel II in Hong Kong. It provides for the new capital adequacy requirements to be operated in accordance with "Capital Rules" and "Disclosure Rules" issued by the Monetary Authority. The Third Schedule to the Banking Ordinance, which sets out how the minimum capital requirement should be calculated under the existing framework, will be repealed when the Capital Rules are made.

There are clear checks and balances in the Banking (Amendment) Ordinance 2005 relating to the Monetary Authority's power to make Capital Rules and Disclosure Rules. First, the Rules will be developed in full consultation with the banking industry. Secondly, they will have the status of subsidiary legislation and will be subject to negative vetting by the Legislative Council. Thirdly, if an AI is aggrieved by certain decisions of the Monetary Authority made under the Capital Rules, it can apply to the Capital Adequacy Review Tribunal – an independent appellate body to be established in 2006 – for a review.

Following enactment of the Ordinance, the HKMA began to develop, in co-operation with the Department of Justice and the Financial Services and the Treasury Bureau, the Capital Rules and Disclosure Rules. Because

of the length and complexity of the Basel II requirements, the banking industry will be consulted in stages in formulating the draft Rules. The first batch was circulated for public comment in December 2005.

New capital adequacy standards under Basel II

During the year, the HKMA continued to develop the standards for implementing the revised framework in relation to each of its three mutually reinforcing components: minimum capital requirement (Pillar 1); supervisory review process (Pillar 2) and market discipline (Pillar 3).

Pillar 1

Since August 2004, the HKMA has issued five detailed consultation packages. These proposals, which have been developed with the support of the industry, cover the core parts of the weighting framework under Basel II, as well as changes to the determination of the capital base to incorporate the latest accounting standards and Basel requirements. To facilitate adoption of the revised framework, AIs are being issued in stages with different parts of a new Capital Adequacy Ratio (CAR) return to assist them in assessing the reporting system changes necessary to ensure compliance. The policy-setting stage was largely completed in 2005.

For AIs intending to adopt the Internal Ratings-based Approach (IRB) for credit risk, the HKMA issued in October a draft guidance note for industry consultation on *Validating Risk-rating Systems under the IRB Approaches*. This received broad support from the banking industry and from other experts in the field, including leading consulting firms. A set of self-assessment questionnaires was also issued to help AIs comply with the relevant IRB requirements of the HKMA.

In monitoring the progress of Als' implementation plans and to develop a more detailed understanding of their rating system, the HKMA is liaising closely with individual Als planning to adopt the IRB Approach between 2007 and 2009. The recognition process has already started in the form of a review of the completed self-assessment questionnaires and supplementary information on the rating systems for those Als aiming to adopt the IRB Approach in 2007.

On operational risk, Als intending to adopt the Standardised Approach must be able to demonstrate to the HKMA's satisfaction that they meet the specific qualifying criteria set out in Basel II. A guidance note on *Operational Risk Management* was issued by the HKMA in November to assist Als in meeting the qualifying criteria. The note sets out the key elements for identifying, assessing, monitoring and controlling operational risk. It also explains the HKMA's approach to the supervision of Als' operational risk.

On market risk, the HKMA reviewed the existing capital framework by incorporating the new standards laid down by the Basel Committee on matters relating to trading-book and internal model recognition. The criteria for granting *de minimis* exemption to Als with minimal market risk were also simplified. The revised regime, which was set out in a consultative paper on *Capital Framework for Market Risk* and supplemented by a revised version of the technical note on *Use of Internal Models to Measure Market Risk*, was issued for industry consultation in December 2005.

The HKMA also reviewed its policy on items eligible for inclusion in regulatory capital, taking into account the adoption of the new Hong Kong Accounting Standards (HKAS) on 1 January 2005 and the latest Basel guidance. After an extensive consultation with the industry, a comprehensive review of the policies of other regulators and an impact analysis to assess the effect of the proposed policy changes on the largest Als, the HKMA issued a discussion paper, *Determination of Capital Base*, in December. It proposes

- standardising the "haircut" for the revaluation reserve on properties and securities holdings at 55%;
- permitting the inclusion of fair-value gains on securities in core capital, subject to an AI being able to demonstrate the adequacy of relevant prudential controls;
- including collective impairment allowance in supplementary capital; and
- deducting all intangible items from core capital.

The proposed changes will closely align the definition of capital base used by the HKMA with the Basel standards and enable the HKMA to respond quickly to future recommendations of the Basel Committee. Further guidance is expected from the Committee relating to the impact on capital of the International Financial Reporting Standards. The Committee has also announced its intention to review the definition of capital base by 2009 to take account of market developments and innovations.

Pillar 2

The main elements of Pillar 2 are already embedded in the HKMA's existing supervisory approach, which provides a good basis for conducting the supervisory review process. Instead of a radical change to existing practices, the implementation of Pillar 2 in Hong Kong will focus on elaboration and refinement. While the HKMA will continue to set the minimum CAR for individual AIs under Pillar 2, the decision will be based on a more detailed and rigorous assessment. To facilitate the conduct of the supervisory review, the HKMA developed a new assessment framework based on its existing risk-based supervisory system. This takes into account an AI's overall risk profile and risk management systems, the extent of the AI's exposure to risks not covered under Pillar 1, and its approach to conducting internal capital assessments. The results of the review will determine the minimum CAR and supervisory priorities for individual AIs. The HKMA will issue details of the proposed assessment framework for industry consultation in the first half of 2006.

Pillar 3

To supplement supervision through improved transparency and market discipline, the recommended disclosures under Pillar 3 will cover the state of affairs of an AI including the profit and loss, capital structure and capital adequacy, risk exposures and risk assessment (qualitative and quantitative). To avoid unnecessary duplication with requirements under other disclosure standards in Hong Kong, the recommended disclosures under Pillar 3 will also take account of the *Hong Kong Financial Reporting Standards 7 Financial Instruments: Disclosures*, and *HKAS 1 Presentation of Financial Statements: Capital Disclosures*. In the case of AIs that are subsidiaries of banks incorporated overseas, the HKMA will take into account disclosures made by the overseas parent in considering whether the disclosure requirements have been met. AIs adopting more sophisticated approaches under the revised framework for calculating capital requirements will generally be subject to higher levels of disclosure. The HKMA intends to issue a consultation paper on the proposed disclosure of information under Pillar 3 in the first quarter of 2006.

Impact of new accounting standards on capital requirements and regulatory reporting

The adoption of International Accounting Standards in Hong Kong on 1 January 2005 has had considerable impact on prudential reporting, interim financial disclosure, and Als' capital base. After conducting a review of the implications for the Hong Kong banking sector and its supervisory framework, the HKMA issued two guidance notes to Als in 2005 – *Impact of the New HKAS on Als' Capital Base and Regulatory Reporting* dated 12 April, and *New HKAS: Impact on Interim Financial Disclosure* dated 11 July.

Initial indications are that the new accounting standards resulted in a significant increase in volatility of earnings for individual Als, although the net effect on a system-wide basis appears to have been relatively modest. However, as the new standards apply to accounting periods beginning on or after 1 January 2005, more time is needed to assess their impact over the longer term.

Prevention of money laundering and terrorist financing

In June 2005, the HKMA launched a structured self-assessment framework to gauge the banking sector's compliance with anti-money laundering and counter-terrorist financing requirements, and to facilitate supervisory monitoring of the compliance position of individual Als. The framework, developed in consultation with the banking industry, was designed to encourage Als to rectify any identified weaknesses as early as possible. An initial review of the self-assessment reports showed a high level of compliance within the banking industry. After a full analysis of the results, the industry will be informed of the overall findings, and any compliance issues requiring closer attention will be highlighted.

The HKMA has also taken steps to improve the conduct of on-site examinations of Als' anti-money laundering and counter-terrorist financing systems and controls.

The examination manual has been revised to incorporate a risk-based approach to conducting examinations including drawing examiners' attention to high-risk products and transactions.

International co-operation

International and regional forums

The HKMA participates in various regional and international forums for banking supervisors, including the Basel Committee's Core Principles Liaison Group, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the South-East Asia, New Zealand and Australia (SEANZA) Forum of Banking Supervisors.

The HKMA is involved in the working group formed under the Basel Committee to review and propose changes to the *Basel Core Principles for Effective Banking Supervision* in the light of new regulatory issues and standards, and the experience gained from the implementation of the *Core Principles* since their publication in 1997. In June, the HKMA hosted a Core Principles Liaison Group meeting in Hong Kong for banking supervisors of more than 20 economies to exchange views on the proposed changes. The meeting provided useful input to the initial drafts of the revised *Core Principles*.



Chief Executive Joseph Yam and Mr Ryozo Himino, Chairman of the Core Principles Liaison Group.

Cross-border implementation of IRB under Basel II

Most Hong Kong-incorporated AIs planning to adopt the IRB Approach are subsidiaries of foreign banking groups. The cross-border implementation of Basel II by these AIs presents challenges to the home supervisors and the HKMA as the host supervisor. The challenges include collaboration over the necessary IRB system validation and dealing with potential differences in the application of IRB requirements and the implementation timetable.

As a member of the Basel Committee Accord Implementation Group's Validation Sub-group, the HKMA took part in its quarterly meetings and contributed to its work across a broad range of issues, including several of the specialised working groups. Participation in the Sub-group also enabled the HKMA to exchange views on IRB system-related validation issues with other leading regulators.

During 2005, the HKMA met the supervisors of large international banks with subsidiary operations in different jurisdictions, including Hong Kong, to review co-ordination in the IRB recognition process. The aims are to avoid supervisory overlap and to reduce the regulatory burden on these banking groups.

Co-operation with overseas supervisors

The HKMA maintains a close working relationship with regulators outside Hong Kong. In 2005, it exchanged letters with the Banking, Finance and Insurance Commission of Belgium, and signed Memorandums of Understanding with the Australian Prudential Regulation Authority and the State Bank of Pakistan to improve supervisory co-operation and the sharing of information with these authorities. The HKMA has also been discussing with a number of overseas supervisory authorities the establishment of similar arrangements.

During the year, meetings were held in Hong Kong and overseas with banking supervisors from the Mainland, Macau, Taiwan, the US, the UK, the Netherlands, Belgium, France, Germany, Switzerland, Japan, South Korea, Indonesia and Malaysia to discuss supervisory issues of common interest.

PLANS FOR 2006 AND BEYOND

Focused examinations

Apart from continuing risk-based on-site examinations of specific institutions, the HKMA plans to carry out a series of focused examinations targeting certain identified macro risks. The scope of these examinations will include detailed checking of the interest rate risk management capability of selected AIs, treasury risk management, wealth management operations and branch operations in Mainland China. The HKMA aims to ensure that AIs have adequate systems and skills to manage the risks and comply with the relevant supervisory requirements. Based on the findings of the examinations, the HKMA will identify and recommend best practices to AIs engaged in these activities.

On anti-money laundering and terrorist financing controls, the HKMA will establish a specialist team of examiners to step up its anti-money laundering supervisory work. The team will conduct tier-2 examinations and benchmarking of selected high-risk areas. Common issues revealed from AIs' self-assessment reports will form the basis for the HKMA to develop longer-term supervisory guidance. Appropriate local and overseas training will be arranged for team members during the year.

Supervision of technology and operational risks

The HKMA will continue to improve its supervision of Internet banking, technology-risk management and business continuity management to keep abreast of the latest developments in these areas. The results of the automated control self-assessments reported by participating AIs in 2005 have highlighted two areas for improvement: data security controls and a comprehensive business continuity plan for dealing with prolonged disruption of banking operations. Two rounds of examinations will be conducted in 2006 focusing on customer data security and business continuity preparedness of AIs for the possible outbreak of an influenza pandemic.

Regular specialist examinations and the automated control self-assessment exercises will also be conducted by the HKMA on Internet banking, technology-risk management and business continuity planning. The HKMA will host the Conference for International Supervisors on Information Technology in 2006, which provides a forum for banking supervisors from 15 major financial markets to share their experiences.

Supervision of ancillary activities

Securities business

The HKMA plans to increase the number of tier-2 securities examinations and to extend the compliance self-assessment process from 30 to 40 registered institutions. In view of the significant growth in the investment advisory activities of registered institutions, the HKMA will also perform theme inspections of their activities, and continue its co-operation with the SFC on the review of regulatory standards on the selling practices of securities intermediaries.

Consultation with the SFC and the banking industry will continue on the proposed revision of the fee structure for AIs' regulated activities under the Securities and Futures Ordinance.

The main aim of the HKMA's securities enforcement function is to protect investors by ensuring that prompt action is taken against those acting improperly in carrying out regulated activities; and that disciplinary action is taken to impose a penalty for wrongdoings and to deter others from engaging in similar conduct. The HKMA plans to complete the upgrading of procedures and resources, which began in 2005, to cope with the growing number of investigation cases. These improvements are expected to lead to a reduction in the time taken to investigate cases and improve operational efficiency. Regular communications with the SFC will continue within the framework set out in the Memorandum of Understanding between the two regulators to promote consistency in enforcement.

Insurance & Mandatory Provident Fund businesses

In 2006, the HKMA plans to conduct examinations focusing on the adequacy of AIs' client suitability assessment when selling insurance and structured products to ensure they are effectively managing the risk of mis-selling. The HKMA will also conduct regular on-site examinations and review half-yearly returns from AIs on insurance-related activities, and maintain a close working relationship with the Insurance Authority.

Developing banking sector infrastructure

The HKMA will focus on the establishment of the Deposit Protection Scheme and the further development of the Commercial Credit Reference Agency in 2006.

Deposit Protection Scheme

The HKMA will assist the Deposit Protection Board in completing the remaining preparatory tasks for the launch of the Scheme. Assuming no unforeseen developments, the Deposit Protection Scheme will begin collecting contributions from banks and providing deposit protection in the second half of 2006. A publicity campaign will be launched to raise the public's awareness of the Scheme and the protection it provides.

Commercial Credit Reference Agency

In 2006, the HKMA in collaboration with the CCRA Industry Working Group will complete the inclusion of sole proprietorships and partnerships in the Agency's database.

Consumer credit data sharing

The HKMA will continue to monitor the benefits of positive credit data sharing according to a set of indicators agreed with the Consumer Council.

Consumer protection

The HKMA will continue to promote improvements in the standard of banking practices through participation in the work of the Code of Banking Practice Committee. It will also monitor AIs' compliance with the Code through the annual self-assessments and handling complaints about banking services.

Basel II implementation

Developing Capital and Disclosure Rules

The HKMA will continue to work in consultation with relevant parties to develop the Capital and Disclosure Rules. There will be two consultative rounds to consider the draft Rules, preliminary discussions with industry associations on the first draft and subsequent statutory consultations on the second draft with the industry associations as well as the Banking Advisory Committee, the Deposit-Taking Companies Advisory Committee and the Financial Secretary. The Rules will then be finalised for submission to the Legislative Council for negative vetting in the third quarter of 2006.

Establishment of Capital Adequacy Review Tribunal

Under the Banking (Amendment) Ordinance 2005, the HKMA plans to establish the Capital Adequacy Review Tribunal and the appeal procedures in 2006. AIs aggrieved by certain decisions made by the Monetary Authority under the Capital Rules can seek a review by the Tribunal. Decisions to be reviewed by the Tribunal are expected to be fundamental issues such as the choice of approach for calculating the CAR, which may have a material impact on the AI's minimum capital requirement.

New capital adequacy standards under Basel II

The HKMA will work closely with the industry to prepare for the implementation of the revised framework in January 2007. Some of the key tasks to be undertaken by the HKMA during 2006 include:

Pillar 1

Finalise the new capital adequacy ratio return and its completion instructions in consultation with the banking industry. Introduce a temporary parallel reporting system using the new return and the existing return to familiarise Als with the new return and assist them in assessing the impact of the new capital standards.

Finalise the guidance note on validating the risk-rating system under the IRB Approach for issue in early 2006, taking into account comments received and any further international development. On-site examinations will also be conducted in early 2006 on Als planning to adopt the IRB Approach in 2007. The recognition process for Als intending to adopt the IRB Approach in 2008 will begin in 2006. Where necessary, discussions will be arranged with Als to ensure a smooth transition and recognition process.

Pillar 2

The new Pillar 2 assessment framework will be further developed in 2006 to ensure that the assessment criteria and methodology are appropriate and to take into consideration comments received during the consultation. A more formal mechanism will be established to ensure the quality, objectivity and consistency of assessments for determining individual Als' minimum CARs, and to improve supervisory transparency and accountability. In future, after

completion of a Pillar 2 assessment, the HKMA will discuss with the AI concerned the results of its assessment, particularly any areas of concern.

The HKMA will review the methodology for assessing the CAMEL rating of Als to harmonise the system with the Pillar 2 process.

Pillar 3

The HKMA plans to issue a consultation paper on financial disclosure in the first quarter of 2006, and to convene meetings of the Working Party on Financial Disclosure and Joint Technical Working Group on Financial Disclosure. Disclosure Rules will then be developed under Section 60A of the Banking (Amendment) Ordinance 2005, to replace the relevant modules of the *Supervisory Policy Manual* relating to financial disclosure by Als, incorporated both locally and overseas.

Executive briefing

To ensure Als take appropriate steps for implementing Basel II, the HKMA has organised a briefing session for the senior executives of institutions to assist them in understanding the underlying objectives, key changes and implications of the revised framework.

 > Basel II

Accounting standards

Developments in accounting standards will be kept under review to assess their potential impact on the banking sector and the HKMA's supervisory framework. This will include liaison with the accounting professions, industry associations and other regulatory bodies. At an international level, initiatives are underway to improve

co-ordination between banking supervisors and accounting standard setters. In particular, the Basel Committee intends to work with the International Accounting Standards Board in reviewing *International Accounting Standard 39 Financial Instruments: Recognition and Measurement*. Further guidance is expected from the Basel Committee on addressing the impact of the new accounting standards on various prudential requirements.

Prevention of money laundering and terrorist financing

The HKMA will strengthen the supervisory framework and monitoring of Als' compliance with the relevant requirements, particularly with regard to deficiencies identified in Als' self-assessment reports. Common issues revealed from the self-assessment results will form the basis for the HKMA to further develop supervisory guidance. To help accomplish this, the HKMA will put more resources into its anti-money laundering efforts, including providing further training to on-site examination staff.

The HKMA also plans to co-ordinate the establishment of specific industry user groups to address anti-money laundering and terrorist financing issues with a higher priority of concern. The aim is to strengthen the banking industry's preparedness to meet new challenges in this area.

To help keep Hong Kong's anti-money laundering framework in line with the latest standards issued by the Financial Action Task Force, the Administration is considering a bill to put the basic obligations relating to customer due diligence and record-keeping into law. The HKMA will work with the Government and financial regulators in drafting the bill, and will seek comments from the banking industry on the proposed legislation when necessary.



MARKET INFRASTRUCTURE

Promoting a sound financial market infrastructure in Hong Kong is a key goal of the HKMA. A comprehensive review of the financial infrastructure of Hong Kong was conducted in the first half of 2005 to develop a safe and efficient multi-currency, multi-dimensional clearing and settlement platform. The Treasury Markets Association has been established by merging the Treasury Markets Forum with the ACI – The Financial Markets Association of Hong Kong to provide a solid structure for developing the treasury markets of Hong Kong.

OBJECTIVES

One of the HKMA's major policy objectives is to promote the development of a safe and efficient financial market infrastructure. This serves two inter-related purposes: helping to maintain financial and monetary stability and supporting Hong Kong's status as an international financial centre. Robust and effective clearing and settlement systems are important in nurturing the competitiveness of Hong Kong's financial sector. The HKMA pays particular attention to these systems for the safe and efficient transfer of funds and securities within Hong Kong and between Hong Kong and other financial centres, in particular the Mainland.

REVIEW OF 2005

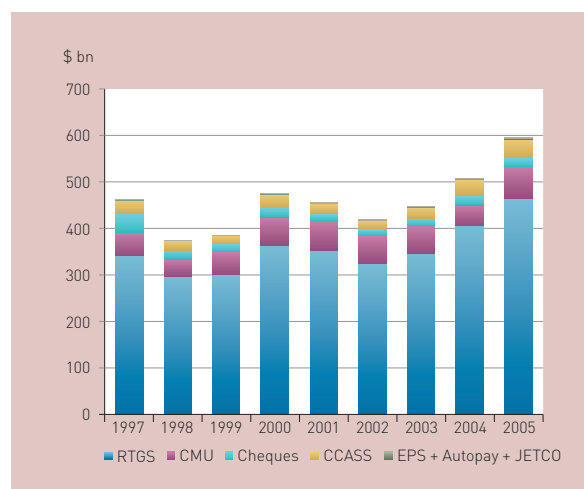
Hong Kong dollar interbank payment system

The Clearing House Automated Transfer System (CHATS), which operates on a real time gross settlement (RTGS) basis, is responsible for clearing all the Hong Kong dollar interbank payments. It has a direct link with the Central Moneymarkets Unit (CMU, the debt securities clearing and settlement system operated by the HKMA) to provide both real-time and end-of-day delivery-versus-payment settlement for transactions involving securities lodged with the CMU. The system

operator of CHATS is Hong Kong Interbank Clearing Limited (HKICL), a company established in 1995 and owned equally by the HKMA and the Hong Kong Association of Banks. In 2005, HKICL processed a daily average value of \$467 billion in CHATS transactions (16,006 items in volume), and \$26.8 billion in CMU transactions (156 items in volume).

Apart from settling large-value payments, CHATS also handles four daily bulk clearings for the money settlement of stock market transactions, cheques and auto-debit, low-value bulk electronic payment items (EPS and auto-credit), and low-value ATM transfers (Chart 1).

Chart 1. Hong Kong dollar payment system daily average turnover

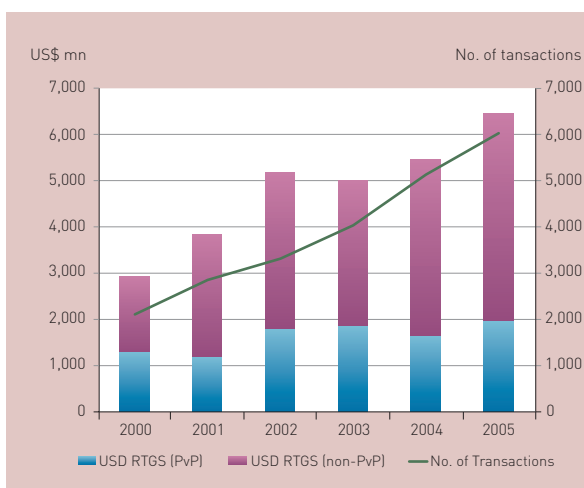


During the year, banks made good use of their Exchange Fund Bills and Notes to obtain interest-free intraday liquidity through intraday repo with the HKMA for settling their interbank payments. On average, \$41 billion worth of intraday repo transactions were carried out daily to facilitate payment flows. This represented 41% of the \$99.7 billion Exchange Fund paper held by banks in December 2005.

US dollar RTGS system

Launched in 2000, the US dollar RTGS system has been operating efficiently. The settlement institution for the US dollar RTGS system is The Hongkong and Shanghai Banking Corporation (HSBC), with HKICL as system operator. In April 2005, HSBC was re-appointed as the settlement institution for a second five-year period. At the end of 2005, there were 68 direct and 162 indirect participants in the system, including 116 indirect participants from outside Hong Kong. In 2005, the system handled more than 6,000 transactions a day with a total value of US\$6.43 billion (Chart 2). An average of more than 5,000 US dollar cheques was processed daily, with a total value of US\$173 million.

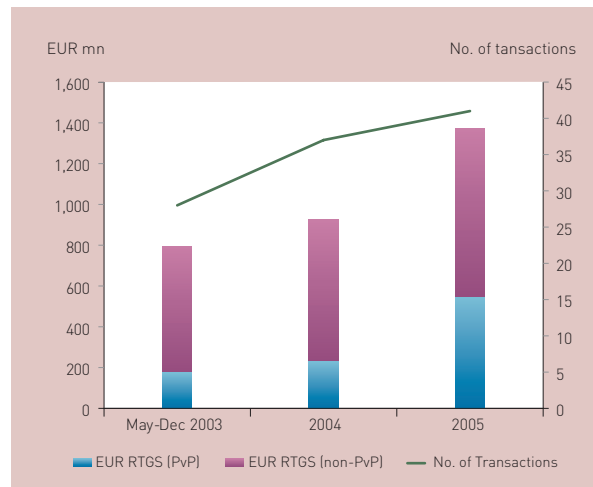
Chart 2. US dollar payment system daily average turnover



Euro RTGS system

The euro RTGS system was launched in 2003. The settlement institution for the euro clearing system is Standard Chartered Bank (Hong Kong) Limited, also with HKICL as system operator. At the end of 2005, there were 23 direct and 22 indirect participants in the system, including 11 indirect participants from outside Hong Kong. In 2005, the system handled on average 41 transactions a day with a total value of €1,374 million (Chart 3).

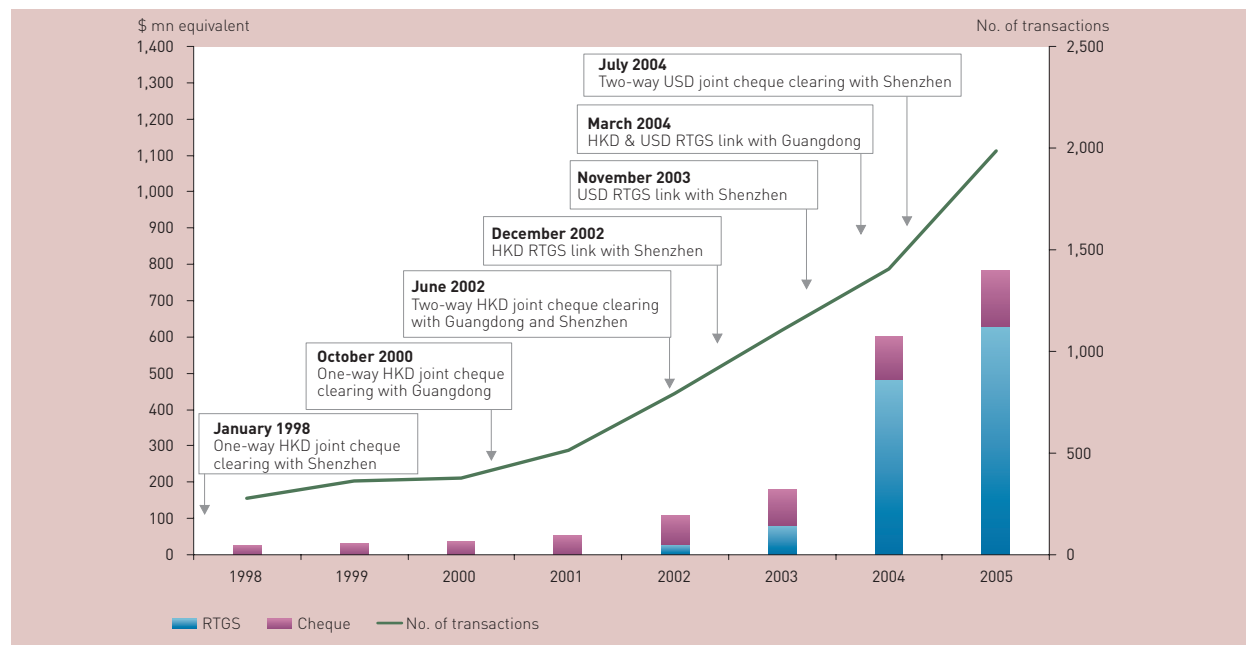
Chart 3. Euro payment system daily average turnover



Payment links with the Mainland

In response to the increasing demand for cross-border payment services, the HKMA has been working closely with the Mainland authorities to establish cross-border payment links since 1998. The development of these payment links is shown in Chart 4. The use of these links has been rising gradually over the years with the increasing economic integration between Hong Kong and the Mainland. The average daily turnover of the links amounted to the equivalent of around \$790 million in 2005 (Chart 4).

Chart 4. Daily average turnover in cross-border links



In 2005, the RTGS system links with Shenzhen and Guangdong Province handled more than 16,000 transactions, with a total value of over \$150 billion. With these links, payments in Hong Kong dollars and US dollars between banks in Hong Kong, Shenzhen and Guangdong Province are settled more effectively and safely.

The cross-border two-way joint cheque clearing facilities cleared around 441,000 Hong Kong dollar and US dollar cheques, with a value of \$36 billion in 2005. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong which were presented in Shenzhen and Guangdong Province, and vice versa.

Debt settlement systems

The CMU provides an efficient clearing, settlement and depository service for both Hong Kong dollar and other international debt securities. Since its establishment in

1990, the CMU has developed links with regional and international central securities depositories. Through these links, overseas investors can hold and settle securities lodged with the CMU efficiently. It also facilitates Hong Kong investors to hold and settle foreign securities held with the relevant regional and international central securities depositories. In addition to facilitating cross-border holdings and trading of international securities, the CMU offers Hong Kong and Asian investors a one-stop service to clear, settle and hold domestic and international securities.

In 2005, the CMU processed a daily average value of \$26.8 billion (156 items in volume) in CMU secondary market transactions. Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of Exchange Fund Bills and Notes (EFBN) was \$126.7 billion and the outstanding amount of other securities was equivalent to \$253.9 billion.

Financial infrastructure review

The HKMA conducted a comprehensive review of Hong Kong's financial infrastructure in the first half of the year. The objective was to establish a coherent development strategy and implementation plan to build a safe and efficient financial infrastructure based on a multi-currency, multi-dimensional platform. The review considered key trends in global financial infrastructure, including new international standards, globalisation and cross-border financial integration, and covered the financial infrastructure related to payment systems, bond market development and integration with the clearing and settlement systems in Mainland China.

In conducting the review, the HKMA analysed global directions, examined current system usage, benchmarked with international best practices, conducted market discussions, identified major challenges and opportunities, and formulated specific action plans to further develop and promote the clearing and settlement systems. The report of the review and its recommendations, in the form of an implementation plan, were endorsed by the Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee in July.

In terms of system development, the review has identified development directions in three main areas – payment systems, the bond market and Mainland-related development needs.

For the **payment system infrastructure**, the goal is to build a safe and efficient multi-currency payment platform to expedite settlement of domestic and international financial transactions to enhance the efficiency of financial intermediation. This can be achieved through expanding the existing links of the three RTGS systems (for Hong Kong dollar, US dollar and euro) with other payment systems in the region and the Mainland. This will help provide one-stop clearing and

settlement services to investors in Hong Kong, the Mainland and the region, and develop Hong Kong into a payment and clearing centre in the region.

For the **bond market infrastructure**, a safe and effective multi-currency bond clearing and settlement platform should be established to facilitate domestic and international financial intermediation. Future challenges will be met by improving the existing infrastructure to support multi-currency bond products, capturing Mainland opportunities and improving Hong Kong's potential as a debt clearing, settlement and custodian centre in the region.

As far as **Mainland-related financial infrastructure** is concerned, the review has identified the need for Hong Kong to develop itself into a conduit to facilitate financial intermediation between the Mainland and the rest of the world. In the near term, the strategy is to prepare Hong Kong for launching the financial infrastructure required to support further expansion of renminbi banking business in Hong Kong. In the long term, the strategy is to develop an infrastructure platform in Hong Kong to serve as a financial intermediation channel for Mainland investors.

In taking forward the recommendations identified in the review, two major areas of work have been identified – project development and business development. Steps have been taken since the second half of 2005 to implement the recommendations.

Project development

Migration to SWIFTNet – this is a major project to replace the existing proprietary platform for the various RTGS systems and the CMU by an open platform to improve the compatibility of the systems with other common clearing and settlement systems. Proposals from prospective vendors have been received. If project

approval by the HKMA and the Hong Kong Association of Banks is obtained, the migration to SWIFTNet is expected to take place in the first quarter of 2008.

Renminbi settlement system – this system is required to cater for the expanded renminbi business, including the new renminbi cheque business announced in October 2005. It is an automated system bearing some of the features of an RTGS system, and can be developed into a fully fledged RTGS system within a short time to cater for further expansion of renminbi business in Hong Kong. The renminbi settlement system commenced operations in March 2006.

RTGS Liquidity Optimiser – this is a new device to settle interbank payment instructions queued in the RTGS system more efficiently by multilateral offsetting deals every 30 minutes. Each of the transactions settled is still on “gross” or “deal by deal” basis. The optimiser helps to remove payment queues and reduce the amount of intraday repo with the HKMA. The device was launched in January 2006 and has been operating smoothly.

CMU Bond Price Bulletin – this is a web-based platform (www.cmu.org.hk) to provide retail investors with easily accessible bond information and indicative prices quoted by individual banks. This website will help promote retail investors’ participation in the secondary market. The website was launched in January 2006.

CMU functional improvements – these include

- processing DvP and collateralisation for Exchange Fund Bills and Notes simultaneously to achieve better liquidity management and greater use of real-time DvP to reduce settlement risk
- establishing an Internet-based CMU front-end enquiry system.

Business development

Expanding system links – in order to develop Hong Kong into a payment and clearing hub for the region, the review has identified the need to explore opportunities for linking the various RTGS systems and the CMU with similar systems in the region, focusing particularly on the greater China region. The HKMA has entered into a Memorandum of Understanding with Bank Negara Malaysia for the establishment of a link between the ringgit RTGS system in Malaysia and the US dollar RTGS system in Hong Kong. This is aimed at eliminating the settlement risk of ringgit/US dollar foreign exchange transactions through PvP settlement in the Asian time zone. The link is expected to go live by the end of 2006.



Executive Director (Monetary Management and Infrastructure) Eddie Yue and Ms Nor Shamsiah Yunus, Assistant Governor of Bank Negara Malaysia sign a Memorandum of Understanding on 8 December 2005.

Promoting system use – while it is important to build state-of-the-art clearing and settlement systems and expand links with other systems in the region, the review found that it is equally important to devise a marketing programme to promote these systems and links. The HKMA has therefore established a comprehensive marketing programme to promote system usage through seminars and visits to potential users in Hong Kong and the Greater China region. In 2005, five seminars were arranged and over 80 marketing calls were made.

Oversight of clearing and settlement systems

The Clearing and Settlement Systems Ordinance (CSSO), which came into force in November 2004, empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. The purpose of the CSSO is to promote the general safety and efficiency of designated clearing and settlement systems including the Central Moneymarkets Unit, the Hong Kong dollar Clearing House Automated Transfer System (CHATS), the Continuous Linked Settlement (CLS) System, the US dollar CHATS and euro CHATS. The CLS system is operated by CLS Bank, which is regulated by its home supervisor, the Federal Reserve Bank of New York with oversight primarily done through the international co-operative oversight arrangement. The HKMA exercises continuous oversight of the other four designated systems through off-site reviews, on-site examinations and meetings with management.

By the end of 2005, the HKMA had completed its first-year oversight cycle. All designated systems were found to be in compliance with the safety and efficiency requirements under the CSSO.

Independent tribunal and committee

An independent Clearing and Settlement Systems Appeals Tribunal was established under the Ordinance to hear appeals by any party aggrieved by a decision of the Monetary Authority on designation and related matters. Since the establishment of the Tribunal there have been no appeals.

In addition, an independent Process Review Committee was established on 1 December 2004 to review processes and procedures adopted by the HKMA in applying standards set under the CSSO to systems in which the

HKMA has a legal or beneficial interest. An *Internal Operating Manual* setting out the procedures adopted by the HKMA for evaluating the designated systems' compliance with the oversight standards has been developed. The Committee used the procedures in the *Manual* as the benchmark to assess whether the HKMA had applied the same set of procedures to all designated systems. Quarterly reports, together with a set of management reports summarising the HKMA's oversight activities, were produced for review by the Committee.

The Process Review Committee held three meetings in 2005 and reviewed four quarterly reports and 21 accompanying oversight activities management reports of the designated systems. The Committee concluded that it was not aware of cases where the HKMA had not followed duly the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities across different designated systems. The Committee's first Annual Report, which can be accessed through the HKMA's website, was submitted to the Financial Secretary in accordance with its terms of reference.

Oversight of retail payment systems

Retail payment systems handle large volumes of transactions of relatively low value. Compared with those of real time gross settlement systems, the retail payment systems generally carry little, if any, systemic risk. The HKMA encourages the industry to adopt a self-regulatory approach through the issuance of, and compliance with, relevant codes of practice. In August 2005, the HKMA endorsed a *Code of Practice for Multi-purpose Stored-value Card Operation*, which is a non-statutory code issued voluntarily by the system operator of the Octopus card. The Code was issued to promote general safety and efficiency in the operation of the multi-purpose stored-value card and to foster public confidence in the system.



Debt market development

Gross issuance of Hong Kong dollar debt increased by 7% to \$402 billion in 2005. In particular, issuance by overseas borrowers (other than Multilateral Development Banks (MDB)) grew by 33% to \$105 billion. Issuance by the Exchange Fund, authorized institutions and local corporations also increased, while that by MDB and statutory bodies and government-owned corporations declined.

The value of outstanding Hong Kong dollar debt rose by 9% to \$664 billion at the end of 2005. Non-MDB overseas borrowers remained the largest issuers, with outstanding debts reaching \$256 billion. In 2005, authorized institutions' total outstanding debts increased by 8% to \$153 billion, possibly reflecting tighter liquidity conditions and increased demand for external funds.

Exchange Fund Bills and Notes programme

The HKMA continued to promote the liquidity and credibility of the benchmark Hong Kong dollar yield curve in 2005. This is achieved by the issuance of more 5, 7 and 10-year EFN, while reducing the issuance of 91-day bills. An increase in the supply of longer-term EFN meets the market demand for quality paper and is conducive to the development of a more efficient and credible long-term Hong Kong dollar benchmark yield curve. The HKMA also conducted regular reviews of the performance of individual market makers, published the daily fixings of prices and yields of EFBN, and monitored the performance of contributors for the fixings, as part of its continuing effort to promote bond market development.

In May 2005, the HKMA re-launched, with certain refinements, the scheme to promote retail investment in the EFN. The number of retail EFN distributors increased from three to seven. The selection of EFN issues for offer to retail investors has become more

flexible with market conditions and distributors' advice being taken into consideration. Retail bids are allotted at the lowest price, or the highest yield accepted at the competitive-bid tender. Since the re-launch, two retail EFN issues have been offered and both were well received by retail investors.

 > [Financial Infrastructure > Debt Market Development](#)

Treasury Markets Forum

The TMF has made significant progress in promoting the development of the treasury markets of Hong Kong. In response to increased demand for renminbi hedging tools following reform of the renminbi exchange rate formation regime in July 2005, the TMF announced in September the launch of the retail renminbi non-deliverable forward contracts. To make it easier for small and medium-sized companies and other retail customers to access the product, the TMF published a standard document setting out the offer terms for the contract, including the settlement arrangements. By the end of the year, 16 banks had joined the programme and launched the product to their customers.

The TMF worked continually with the ACI – The Financial Markets Association of Hong Kong (ACIHK) in 2005 to promote membership of the ACIHK to treasury market practitioners. By the end of 2005, ACIHK membership increased to more than 2,000, from around 1,800 a year previously. The TMF co-operated with other industry bodies in organising functions to keep market participants abreast of the latest market and product developments, including a two-day Professional Repo Market Course in October and a three-day Global Government Bond Conference in November. Both events were organised for the first time in Asia and were well received. The TMF also participated in the Hong Kong Financial Services Expo in Shanghai for the second year to promote Hong Kong's treasury markets to the Mainland.

The TMF continued to work on a number of market-related issues in 2005, such as non-deliverable forward documentation, review of interest-adjustment rates, review of Hong Kong Dollar interest rate swap fixing and the setting up of a USD/HKD fixing.

Establishment of the Treasury Markets Association

Consolidating the success achieved by the TMF, the Treasury Markets Association (TMA) was formed by merging the TMF with ACIHK in December 2005. The TMA is incorporated as a company by guarantee under the Companies Ordinance, which gives the TMA a more solid institutional structure to promote the professionalism and competitiveness of the treasury markets in Hong Kong. The new organisation has two types of members – institutional members, including financial institutions, brokers and corporates involved in the treasury markets; and individual members, who are practitioners in the treasury markets. The participation of both institutional and individual members allows the TMA to bring together forces within the industry to promote the treasury markets and improve Hong Kong's status as an international financial centre.

The management of the TMA is entrusted to the Executive Board of TMA, which is chaired by Mr Y K Choi, Deputy Chief Executive of the HKMA, and comprises representatives from institutional members, individual members and the HKMA. The Association has also established a Council to provide strategic advice to the Executive Board on matters relating to the TMA. Mr Joseph Yam, Chief Executive of the HKMA, has been invited to be the Honorary President of the Council. Senior executives in the banking and treasury industries and prominent academics serve as Council members. The Executive Board has set up five committees to assist it in carrying out its work. They are the Codes and Standards Committee, the Market and Product

Development Committee, the Professional Membership Committee, the Publicity and Communications Committee and the Finance and Administration Committee.

PLANS FOR 2006 AND BEYOND

The HKMA will continue to focus its efforts on ensuring the safe and efficient operations of the various RTGS systems and the CMU for maintaining the stability and integrity of the financial system in Hong Kong. It will continue to implement the recommendations identified in the financial infrastructure review and build a safe and efficient multi-currency, multi-dimensional financial infrastructure platform.

The HKMA will continue to explore opportunities for PvP links between Hong Kong's US dollar RTGS system and those of other Asian currencies. Setting up DvP links between Asia's debt clearing and settlement systems and the US dollar RTGS system in Hong Kong is also part of the expansion plan. To promote Hong Kong's infrastructure network, the HKMA will work closely with strategic partners, such as settlement institutions, central banks and industry associations to launch various marketing activities. These will be monitored and progress reports will be submitted regularly to the Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee.

As an overseer of designated systems under the Clearing and Settlement Systems Ordinance, the HKMA will be involved in promoting the safety and efficiency of these systems through continual compliance monitoring. In addition to the large-value interbank payment items, the HKMA plans to extend its oversight in 2006 to include small-value interbank payment items such as paper cheques, so that all interbank payments will be brought under the statutory oversight regime.

As part of the informal oversight framework of retail payment systems, the HKMA plans to work with the credit card industry to develop a code of practice for credit card scheme operators in Hong Kong. It will continue to monitor developments in the payment industry in Hong Kong and, where necessary, refine its oversight framework.

With the aim of developing the domestic debt market, a review of the market will be undertaken in 2006. As part of that exercise, the HKMA will review the EFBN programme to consider ways to further improve market liquidity of these instruments.

The refined retail EFN scheme will continue to operate in 2006, under which selective EFN issues will be opened for non-competitive tender by retail investors. The programme will be reviewed in mid-2006 after the first year's operation of the re-launch.

The HKMA will continue to work closely with the Treasury Markets Association to develop Hong Kong's treasury markets.



INTERNATIONAL FINANCIAL CENTRE

Hong Kong's status as an international financial centre was further strengthened in 2005. The HKMA was involved in several key initiatives, including the successful launch of the second phase of Asian Bond Fund, expansion of renminbi banking business in Hong Kong, and upgrade of Hong Kong's sovereign credit rating. Through participation in international financial institutions and central banking forums, the HKMA also contributed to a greater understanding of Hong Kong's financial and economic development within the international financial community.

OVERVIEW

Conditions in the global financial system were favourable in 2005, supported by an improved world economic outlook, despite rising interest rates, high oil prices and persistent external imbalances. A significant development in Asia was the reform of the renminbi exchange rate regime on 21 July 2005. The move was welcomed by the international financial community and this was reflected in the calm reaction of financial markets in Hong Kong and other parts of the world. Against this background, the HKMA played a leading role in co-operation and discussions at international and regional financial and central banking forums. Working with other Asian central banks, the HKMA led the successful launch of the second phase of Asian Bond Fund (ABF2), contributing to the development of bond markets in Hong Kong and the region.

The increasing economic integration between Hong Kong and Mainland China resulted in a continued strengthening of communications and co-operation between the HKMA and Mainland authorities. The scope of renminbi business in Hong Kong, with the related clearing arrangements being provided by the People's Bank of China, was expanded during 2005.

REVIEW OF 2005

Development of regional bond markets

A milestone in the development of regional bond markets was achieved in 2005 with the HKMA, through its chairmanship of the EMEAP Working Group on Financial Markets, playing a leading role in the launch of ABF2.

Asian Bond Fund 2

The local currency-denominated ABF2, an extension of the US dollar-denominated Asian Bond Fund (ABF1) launched in June 2003, is designed to broaden and deepen the domestic and regional bond markets in Asia.

ABF2 comprises a Pan-Asia Bond Index Fund (PAIF) and eight Single-market Funds. The PAIF is a single-index bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in all EMEAP markets except Australia, Japan and New Zealand. Each of the eight Single-market Funds invests in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective EMEAP markets. The PAIF and eight Single-market Funds, which are passively managed by private-sector fund managers, seek to track the performance of the iBoxx ABF indices, a set of pre-determined and transparent bond indices provided by the Frankfurt-based International Index Company.

ABF2 has yielded important benefits:

- **A low-cost new asset class in Asia with low entry threshold:** The component funds of ABF2 are structured to keep the expense ratio and the minimum investment amount as low as possible to make them more appealing to a broad investor base.
- **Removal of cross-border restrictions:** ABF2 was instrumental in lifting cross-border restrictions to allow greater participation by foreign investors in several EMEAP markets.
- **Enhancing market liquidity:** Market-making arrangements have been introduced to improve the liquidity of ABF2's component funds by maintaining tight bid-ask spreads.
- **Improving price transparency:** Structuring ABF2 component funds where appropriate as exchange-traded funds has helped improve price transparency by making information on trading and order flows available to investors. ABF2 has chosen a set of transparent, replicable and credible bond indices – the iBoxx ABF family of indices – under which the benchmark index performance can be tracked closely by private-sector fund managers.
- **Improving market infrastructure:** ABF2 has accelerated the linking of clearing and settlement systems for equity and debt securities in some EMEAP markets. The global custodian for PAIF and the eight Single-market Funds has also established Asia's first custodian network linking all eight EMEAP markets.

In May 2005, the HKMA, together with the other 10 EMEAP central banks and monetary authorities, announced the completion of funding for ABF2 and the appointment of the master custodian and fund managers for its nine component funds. The EMEAP Group's initial investment in ABF2 amounted to US\$2 billion, of which US\$1 billion was allocated to the PAIF and the remaining US\$1 billion among the eight Single-market Funds. Preparations began soon afterwards for offering the nine funds to other public and private-sector investors. By the end of 2005, the PAIF and three Single-market Funds of Hong Kong, Malaysia and Singapore had been listed. Subject to the approval of the relevant authorities, the remaining five Single-market Funds are expected to be offered to the public in the first half of 2006. ABF Hong Kong Bond Index Fund and the PAIF – two key components of ABF2 – were listed on the Stock Exchange of Hong Kong in June and July 2005 respectively. The two funds have been well received by investors. In particular, the number of outstanding units of the ABF Hong Kong Bond Index Fund has grown by 51% since its listing.

Expansion of renminbi business and financial integration with the Mainland

Renminbi business in Hong Kong has developed steadily since its launch in early 2004. At the end of 2005, renminbi deposits totalled RMB22.6 billion yuan (more than 428,000 renminbi deposit accounts), with 38 banks (most of the retail banks) in Hong Kong offering renminbi banking services.

With such favourable response, the plan is to further develop the business along three strategic directions: (i) diversification of the renminbi assets and liabilities of Hong Kong banks; (ii) provision of appropriate renminbi

banking services for trade and other current-account transactions between Hong Kong and the Mainland; and (iii) establishment of a renminbi debt issuance mechanism in Hong Kong.

Some progress was made during 2005 with the scope of renminbi business in Hong Kong being expanded in several areas. Since December 2005, the definition of designated merchants has been widened, and designated merchants can open renminbi deposit accounts, in addition to conducting one-way exchange of their renminbi receipts into Hong Kong dollars. Limits for exchange and remittance of renminbi by individuals have been relaxed and the cap on credit limits for renminbi cards issued by participating banks has been removed. With the launch in March 2006 of the new Renminbi Settlement System, which caters for the expanded renminbi business and ensures more efficient settlement of renminbi transactions, Hong Kong residents are able to use renminbi cheques for consumer spending in Guangdong Province. The HKMA is also continuing its discussions with the relevant Mainland authorities on proposals for settling cross-border trade in renminbi and the issuance of renminbi bonds in Hong Kong.

A further concession was achieved for Hong Kong banks operating on the Mainland under the third phase of the Closer Economic Partnership Arrangement (CEPA III) signed on 18 October 2005. The level of operating funds required for branches of Hong Kong banks on the Mainland offering renminbi and foreign currency business to local customers under CEPA III will be assessed on an aggregate basis. The requirement for each individual Mainland branch has been relaxed to RMB300 million yuan on the condition that the average level of operating funds of all Mainland branches of the bank concerned is not less than RMB400 million yuan.

As part of its effort to keep up with financial and economic developments on the Mainland, the HKMA continued to engage in research co-operation and discussions with Mainland academics and think-tanks. During 2005, a number of Mainland officials and academics were invited to Hong Kong to exchange views

on issues of common interest. A topic which has been receiving considerable attention as a result of the increasing economic integration between Hong Kong and the Mainland is Hong Kong's role as an international financial centre in the light of the Mainland's changing circumstances.

The role of Hong Kong as an international financial centre in the light of changes on the Mainland

The most significant development affecting Hong Kong's role as an international financial centre in the past few decades has been the rapid economic growth of the Mainland and its expanding needs for financial intermediation. So far, the financial sector in Hong Kong has taken advantage of this development, mainly through the equity market by serving as the primary location for Mainland companies to raise foreign capital. By the end of 2005, 209 Mainland companies (H-shares and red chips) were listed on the Stock Exchange of Hong Kong, accounting for one third of total market capitalisation and 40% of market turnover. In 2005, nearly \$180 billion (or 60% of the market total) was raised by Mainland companies.

The changing circumstances

The reliance of Mainland enterprises on Hong Kong as a fund-raising centre reflects to a large extent the deficiencies in financial intermediation in Mainland China. However, as financial sector reform and liberalisation proceed, questions are being raised as to how long fund-raising activities by Mainland enterprises will continue to be conducted in Hong Kong. The Mainland's need for inward cross-border financial intermediation is likely to become smaller as domestic savings are substantial (a savings rate of over 40%). With domestic commercial banks on the Mainland holding excessive liquidity, the need for bringing in additional foreign capital through fund-raising in Hong Kong or other financial centres abroad is also being questioned.

The way ahead

To maintain Hong Kong's position in the Mainland's financial intermediation process, Hong Kong needs to play a role not only in intermediating funds between the Mainland and the rest of the world, but also in the domestic intermediation process: In essence, marrying the needs of both savers and fund-raisers from the Mainland. In practical terms, it means:

- (i) For financial services that need to be provided on location, such as retail banking, access on the Mainland by Hong Kong financial institutions needs to improve. To some extent, work in this area has begun with the Closer Economic Partnership Arrangement and other channels already helping to lower entry barriers in the past few years;
- (ii) For financial services that are not required to be provided on location, such as capital market activities, improved mobility from the Mainland to Hong Kong will be required for investors and investment funds through, for instance, qualified domestic institutional investor schemes; and for fund raisers, to obtain financing through banks and the equity and debt markets in Hong Kong with fewer restrictions.

While Hong Kong's multi-currency, multi-dimensional payment system, which supports efficient international financial intermediation, puts Hong Kong in a good position to take on such an expanded role, more needs to be done. First, Hong Kong should increase its capability to handle financial transactions denominated in renminbi. The development of renminbi business in Hong Kong is an important step in this direction. Secondly, when the need arises, links in the financial infrastructure, particularly those of the payment, clearing, settlement and custodian systems between the Mainland and Hong Kong, should be further improved for the orderly, safe and efficient cross-border movement of funds and financial instruments.

The proposition of an expanded role for Hong Kong in the Mainland's financial intermediation, which requires even greater co-operation, should be seen in the context of increasing integration between the two economies. The participation of Hong Kong intermediaries in the Mainland's domestic financial intermediation process, whether on location or not, will benefit both Hong Kong and the Mainland. The introduction of new products and technical transfers in risk management and product development will help the Mainland market to mature, and the expansion of renminbi business in Hong Kong provides a testing ground for the gradual move to renminbi convertibility. There are benefits for both sides, and further discussions are envisaged for the next step in this area of closer integration.

Upgrading Hong Kong's sovereign credit rating

The HKMA continues to play a major role in adopting a more proactive approach towards international credit rating agencies on Hong Kong's credit ratings. Through more effective communication between the international credit rating agencies and the relevant authorities, the HKMA's role is to ensure the agencies maintain a more balanced view on Hong Kong. These efforts paid off during 2005 amid improved economic prospects in Hong Kong. In July 2005, Standard & Poor's upgraded Hong Kong's foreign currency sovereign credit rating by one notch to AA- from A+. Moody's, Fitch Ratings, and Rating and Investment Information all affirmed Hong Kong's sovereign credit ratings in 2005.

Regional monetary co-operation and participation in multilateral institutions

The HKMA continued to contribute to policy dialogue in international and regional forums and was involved in regional monetary co-operation in 2005. The HKMA's Chief Executive became a member of the Review Group on the Organisation of Financial Sector and Capital Markets Work of the International Monetary Fund. The Review Group advised the IMF's Managing Director on ways to restructure its existing framework for improving the effectiveness of financial sector analysis and surveillance activities. The HKMA also participated in meetings of the Asia-Pacific Economic Co-operation (APEC) forum, the Financial Stability Forum and the Bank for International Settlements, and in regional central banking co-operation. Through its involvement with the Working Group on Offshore Financial Centres of the Financial Stability Forum, the HKMA supported the promotion of supervisory and regulatory standards and better practices in information sharing and cross-border co-operation by offshore financial centres.

Training

The training programmes for officials of the People's Bank of China (PBoC), the China Banking Regulatory Commission (CBRC) and other Mainland authorities in Hong Kong and the Mainland expanded in the scope of training, and the number of courses conducted and people trained in 2005. The courses covered areas in financial stability, banking supervision, financial infrastructure, accounting management and market analysis. They included

- two banking supervision courses for senior officials of CBRC
- nine specialised courses for CBRC bank supervisors
- three financial stability courses for senior officials of PBoC
- one bank accounting management course for PBoC accounting officials
- one financial stability and market analysis seminar for PBoC market research officials
- two clearing and settlement infrastructure courses for PBoC clearing officials
- one course for securities regulators of the China Securities Regulatory Commission
- one course for officials of the State Administration of Foreign Exchange.

In total, 20 courses, or 4,095.5 days of training, were provided to 1,129 Mainland officials in 2005.

The HKMA also provided training on request to other external parties, including courses for Mainland commercial banks and a regional course on Risk-focused Supervision and Risk Assessment under the APEC financial regulators' training initiative. A total of 206 participants attended these seminars in 2005.

PLANS FOR 2006 AND BEYOND

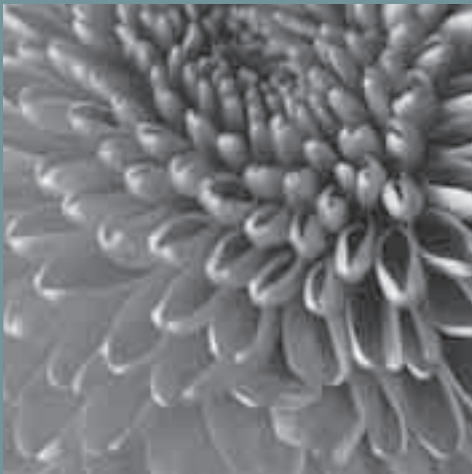
The HKMA will continue to monitor developments in globalisation and financial integration, and will ensure the views and concerns of Hong Kong on other important issues, such as financial stability and monetary co-operation are heard in central banking and international financial forums.

In further developing Hong Kong as a premier international financial centre, the HKMA will work with the Government in nurturing a deeper understanding of Hong Kong's economic and financial strengths among major international credit rating agencies. The HKMA will also co-operate with other EMEAP central banks and fund managers to launch the remaining five Single-market Funds under ABF2 in 2006.

Integration between Hong Kong and the Mainland is expected to strengthen in the years ahead with the continued development and expansion of renminbi business in Hong Kong and the full implementation of the three phases of CEPA. The HKMA will maintain close relations with the Mainland to promote Hong Kong's role in facilitating fund flows and serving the financial needs of Mainland China, as well as organising training seminars and courses for the staff of Mainland authorities and other external parties.

 > [Monetary Stability](#) > [External Relations](#)

 > [Press Releases](#) > [International Relations](#)



RESERVES MANAGEMENT

The investment environment was difficult in 2005 with global financial markets pulling in different directions. Rising energy prices and continued monetary tightening in the US stifled the US equity and bond markets, while a 13.2% depreciation of the euro and the yen against the US dollar offset some of the gains in the euro-zone and Japanese equities. Against this backdrop, the Exchange Fund achieved an investment return of 3.1% in 2005, which was 0.2% better than the return on its benchmark.

THE EXCHANGE FUND

The primary objective of the Exchange Fund is to safeguard the exchange value of Hong Kong's currency and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. It is also the investment objective of the Fund to maintain the long-term purchasing power of the Fund, which represents a store of value for the people of Hong Kong.

The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment process and the need to diversify into new markets and instruments. The management of the Fund by the HKMA is in line with international best practices.

Investment objectives and benchmark

The Exchange Fund's long-term asset allocation strategy is governed by the investment benchmark approved by the Financial Secretary after consultation with the Exchange Fund Advisory Committee (EFAC). The investment benchmark, which represents an optimal mix of assets, is designed to meet the following investment objectives:

- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term US dollar-denominated securities;

- (c) to ensure that sufficient liquidity will be available for the purposes of maintaining monetary and financial stability; and

- (d) subject to (a)–(c), to achieve an investment return that will preserve the long-term purchasing power of the Fund.

The investment benchmark is reviewed regularly to ensure that it is able to meet the investment objectives consistently. Under the current benchmark, which was established in January 2003, 77% of the Fund is allocated to bonds and 23% to equities and related investments. In terms of currency allocation, 88% is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund is managed as two distinct portfolios — the Backing Portfolio and the Investment Portfolio. Since September 1998, the Hong Kong dollar Monetary Base was re-defined to include Exchange Fund Bills and Notes in addition to Certificates of Indebtedness, government-issued notes and coins in circulation and the aggregate clearing balance maintained by banks with the HKMA. Under the Currency Board arrangements, the Hong Kong dollar Monetary Base must be at least 100% backed by US dollar reserves held in the Exchange Fund. The objective of the Backing Portfolio is therefore to hold highly liquid US dollar-denominated securities to provide a full backing to the Monetary Base.

The balance of the Exchange Fund assets is held in the Investment Portfolio which invests primarily in OECD bond and equity markets to preserve the value and long-term purchasing power of the Fund.

The investment benchmark defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund. To qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Exchange Fund.

Apart from the investment benchmark, EFAC also determines the Exchange Fund's investment strategy at its regular meetings having regard to the latest market conditions. Based on the investment strategy endorsed by EFAC, the Reserves Management Department of the HKMA is responsible for making day-to-day investment decisions for the Exchange Fund with the help of fundamental analyses of different economies and assessments of market developments and trends.

Use of external managers

Apart from managing assets internally through the Reserves Management Department, the Exchange Fund also employs external fund managers, located in 14 international financial centres, to manage about one third of its assets, including all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, capture a diverse mix of investment styles within the global investment field, and transfer knowledge and information from the market to the in-house professionals. In 2005 the Exchange Fund has expanded its investments to accept a wider range of management styles and markets through the employment of additional

external managers, to gain market depth and improve returns. Externally managed portfolios are subject to the same stringent controls and investment guidelines as the internally managed portfolios. Assets acquired by the external managers are placed with major global master custodians.

Equity portfolios

The management of the Hong Kong equity portfolios was transferred to the HKMA in January 2003 from Exchange Fund Investment Limited. The HKMA manages these portfolios, and other global equity portfolios, exclusively through external fund managers.

Risk management and compliance

Stringent controls and investment guidelines have been established to monitor the risks arising from increasing volatility in the financial markets. In addition, the HKMA conducts detailed performance attribution analyses to make the most effective use of the investment skills of both the internal and the external managers. To measure risk exposure properly, risk-control tools such as value-at-risk and scenario stress testing are deployed to assess market risks incurred by the various investment portfolios under normal and extreme adverse market conditions.

 > [Monetary Stability > Exchange Fund](#)

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2005

2005 was marked by a significant rise in energy prices and the continued removal of the accommodative monetary policy stance by the US Federal Reserve. The price of crude oil rose from US\$43.5 a barrel at the beginning of 2005 to US\$61 at the end of the year, and

the US Federal Reserve raised the federal funds target rate eight times during the year, each time by 25 basis points, to 4.25%. This tightening drove up the short-end of the US Treasury yield curve. However, the long-end of the curve remained largely steady as the higher energy prices apparently did not trigger any inflation expectation. As a result, the US Treasury yield curve flattened noticeably with 2-year and 10-year US Treasury yields closing at 4.40% and 4.39% respectively.

Global equity markets showed mixed results in 2005. Improving economic prospects in Japan sent TOPIX up by 43.5%, while the major European stock indices rose by 13-33%. The US and Hong Kong equity markets, on the other hand, showed less impressive results as higher interest rates hurt investor sentiment. The S&P 500 ended the year only 3.0% higher, while the Hang Seng Index rose by 4.5%.

Rising US interest rates provided strong support for the US dollar in 2005, with the euro and the yen depreciating by 13.2% against the US dollar. Supported by upbeat global demand, commodity prices continued to fare well. Gold prices surged by 18% to close at US\$517 an ounce.

The performance of major bond, equity and currency markets in 2005 is shown in Table 1.

Table 1. 2005 market returns

Currencies	
Appreciation(+)/depreciation(-) against US dollar	
Euro	-13.2%
Yen	-13.2%
Bond markets	
Relevant US Government Bond (1-3 years) Index	+1.6%
Equity markets	
Standard & Poor's 500 Index	+3.0%
Hang Seng Index	+4.5%

The Exchange Fund's performance in 2005

Amid the difficult investment environment, the Exchange Fund earned a gross investment income of \$38.2 billion in 2005, comprising \$30.2 billion from bond investments, \$7.0 billion from Hong Kong equities, \$20.5 billion from foreign equities, and a foreign exchange revaluation loss of \$19.5 billion. The total investment income represents an investment return of 3.1%, about 0.2% better than the return of the investment benchmark for the year.

Table 2 shows the annualised investment return of the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1994 to 2005. In addition, the annual return of the Exchange Fund

Table 2. Gross investment return of the Exchange Fund (in Hong Kong dollar terms) ¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2005	3.1%	2.9%	+1.7%
2004	5.7%	5.7%	+0.4%
1994-2005 annualised	6.3%	N/A	+1.3%
1999-2005 annualised	5.7%	4.5%	-1.3%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.
² Established in January 1999.
³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.

from 1994 to 2005 is set out in Chart 1. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2005 is shown in Chart 2. Since 1994, the Exchange Fund has generated a compounded annual return of 6.3%, which compares favourably with the compounded annual inflation rate of 1.3% over the same period. The currency mix of the Fund's assets at 31 December 2005 is in Table 3.

Chart 1. Investment return of the Exchange Fund (1994-2005)

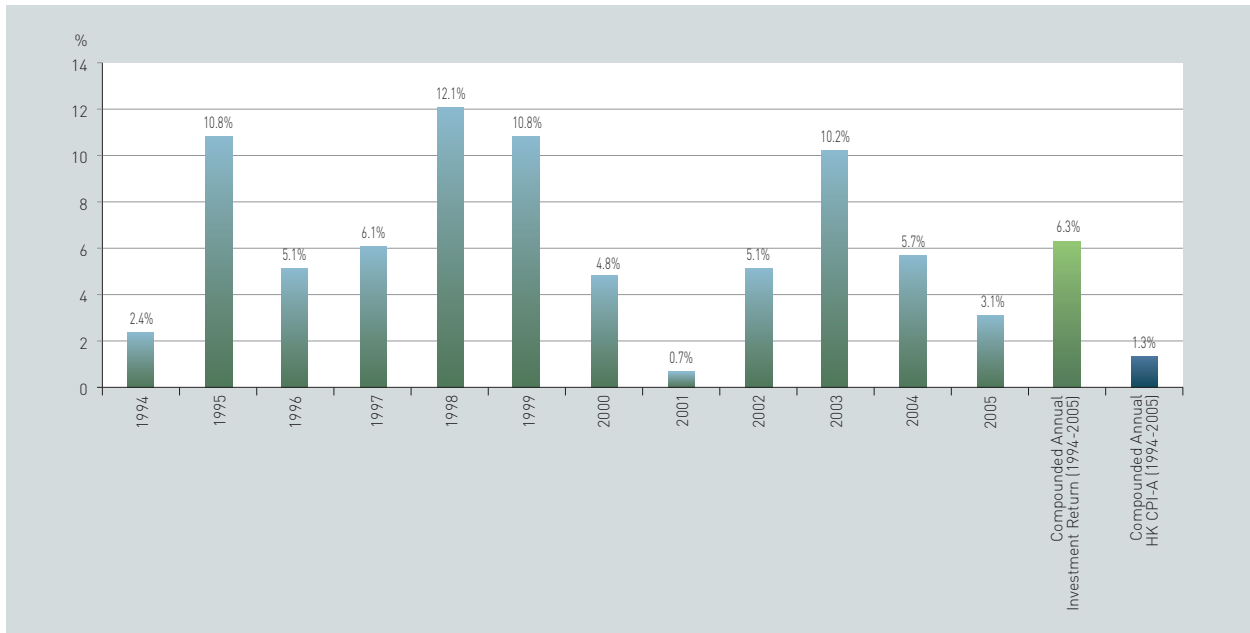


Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2005)

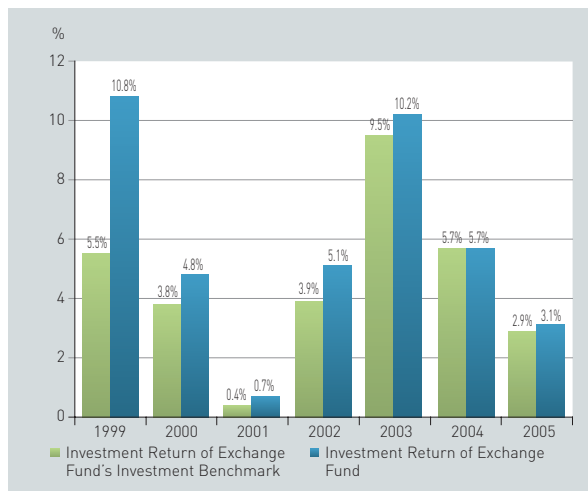


Table 3. Currency mix of the Exchange Fund's assets on 31 December 2005 – including forward transactions

	HK\$ billion	%
US dollar bloc		
US dollar *	843.2	79.0
Hong Kong dollar	95.6	9.0
Non-US dollar bloc	128.0	12.0
Total	1,066.8	100.0

* Includes US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

Transparency

The information disclosure of the Exchange Fund is one of the most transparent among central banks and monetary authorities. Four press releases on Exchange Fund data are issued by the HKMA each month. Three of these releases disseminate monetary data in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard. The International Reserves constitute the official currency reserves of Hong Kong and the analytical accounts of the central bank comprise specifically prescribed balance sheet data. The template on international reserves and foreign currency liquidity provides a comprehensive account of the IMF participants' foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The fourth release, the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of transparency, which helps promote public assessment and understanding of the Exchange Fund's operating results and financial position.

 > [Press Releases](#) > [Exchange Fund](#)

THE EXCHANGE FUND

- Report of the Director of Audit to the Financial Secretary
- Exchange Fund – Income and Expenditure Account
- Exchange Fund – Balance Sheet
- Exchange Fund – Statement of Changes in Equity
- Exchange Fund – Cash Flow Statement
- Exchange Fund – Notes on the Accounts

REPORT OF THE DIRECTOR OF AUDIT TO THE FINANCIAL SECRETARY

I have audited the statement of the accounts on pages 98 to 173 which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

The directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) requires the Monetary Authority to sign the statement of the accounts. In preparing the statement of the accounts, the Monetary Authority has to select appropriate accounting policies and to apply them consistently.

It is my responsibility to form an independent opinion, based on my audit, on that statement of the accounts and to report my opinion to you.

Basis of opinion

I certify that I have audited the statement of the accounts referred to above in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the statement of the accounts. It also includes an assessment of the significant estimates and judgements made by the Monetary Authority in the preparation of the statement of the accounts, and of whether the accounting policies are appropriate to the Exchange Fund's and the Group's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance as to whether the statement of the accounts is free from material misstatement. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the statement of the accounts. I believe that my audit provides a reasonable basis for my opinion.

Opinion

In my opinion the statement of the accounts gives a true and fair view of the state of affairs of the Exchange Fund and of the Group as at 31 December 2005 and of their surplus and cash flows for the year then ended and has been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Audit Commission
Hong Kong
30 March 2006

(Benjamin Tang)
Director of Audit

EXCHANGE FUND - INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
INCOME					
Interest income		31,307	24,598	29,719	23,574
Dividend income		5,165	4,556	5,430	4,573
Net realised and revaluation gains		22,173	20,120	22,182	20,120
Net exchange gains/(losses)		(19,468)	8,469	(19,474)	8,474
Investment income	4(a)	39,177	57,743	37,857	56,741
Bank licence fees		129	129	129	129
Other income		308	353	36	70
TOTAL INCOME		39,614	58,225	38,022	56,940
EXPENDITURE					
Interest expense	4(b)	(16,990)	(18,066)	(16,026)	(17,856)
Operating expenses	4(c)	(1,626)	(1,454)	(1,463)	(1,271)
Note and coin expenses	4(d)	(208)	(182)	(208)	(182)
Write back of impairment losses on loans/ (Provisions made for bad and doubtful loans)	4(e)	19	(89)	-	-
TOTAL EXPENDITURE		(18,805)	(19,791)	(17,697)	(19,309)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE		20,809	38,434	20,325	37,631
Share of profit of associate, net of tax		3	3	-	-
SURPLUS BEFORE TAXATION		20,812	38,437	20,325	37,631
Income tax		(100)	(109)	-	-
SURPLUS FOR THE YEAR		20,712	38,328	20,325	37,631
ATTRIBUTABLE TO:					
Owner of the Fund		20,689	38,307	20,325	37,631
Minority interests		23	21	-	-
		20,712	38,328	20,325	37,631

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - BALANCE SHEET

as at 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
ASSETS					
Cash and money at call	6	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	7	75,648	48,178	73,120	42,747
Derivative financial instruments	8(a)	1,950	1,438	1,865	1,438
Financial assets designated at fair value through profit or loss	9(a)	953,145	–	953,145	–
Other investments in securities	9(b)	–	977,746	–	977,746
Available-for-sale securities	10(a)	2,483	–	493	–
Investment securities	10(b)	–	300	–	300
Held-to-maturity securities	11	4,605	4,130	–	–
Mortgage loans	12	29,476	34,938	–	–
Gold	13	266	228	266	228
Other assets	14	17,015	13,398	16,149	12,476
Investments in subsidiaries	15	–	–	2,145	2,145
Investment in associate	16	26	23	–	–
Property, plant and equipment	17	888	885	625	635
Operating land lease prepayment	18	3,071	3,145	3,071	3,145
Intangible assets	19	33	42	33	42
TOTAL ASSETS		1,104,543	1,105,210	1,066,799	1,061,640
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	148,406	146,775	148,406	146,775
Government-issued currency notes and coins in circulation	20	6,671	6,351	6,671	6,351
Balance of the banking system	21	1,561	15,789	1,561	15,789
Derivative financial instruments	8(a)	834	2,372	525	2,372
Trading liabilities		7,412	100	7,412	100
Placements by banks and other financial institutions	22	25,712	39,087	25,712	39,087
Placements by other Hong Kong Special Administrative Region government funds	23	297,086	280,091	297,086	280,091
Exchange Fund Bills and Notes issued	24	118,134	125,860	118,134	125,860
Other debt securities issued	25	27,991	35,495	–	–
Other liabilities	26	24,636	27,499	18,146	21,838
Total liabilities		658,443	679,419	623,653	638,263
Accumulated surplus	27	445,828	425,624	443,146	423,377
Available-for-sale securities revaluation reserve	27	94	–	–	–
Total equity attributable to owner of the Fund		445,922	425,624	443,146	423,377
Minority interests	27	178	167	–	–
Total equity		446,100	425,791	443,146	423,377
TOTAL LIABILITIES AND EQUITY		1,104,543	1,105,210	1,066,799	1,061,640

Joseph Yam

Monetary Authority
30 March 2006

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2005

[Expressed in millions of Hong Kong dollars]	NOTES	Group			2004 (restated)		Fund		
		2005	2005	2005	2004	2004	2005	2004	
		Attributable to owner of the Fund	Minority interests	Total equity	Attributable to owner of the Fund	Minority interests	Total equity	Attributable to owner of the Fund	(restated)
Total equity at 1 January									
As previously reported		425,838	-	425,838	386,450	-	386,450	423,591	384,879
Reclassification of minority interests to equity		-	167	167	-	160	160	-	-
Prior year adjustment arising from changes in accounting policies under HKAS 16 and 17	27	(214)	-	(214)	867	-	867	(214)	867
As restated before opening balance adjustment		425,624	167	425,791	387,317	160	387,477	423,377	385,746
Opening balance adjustment arising from changes in accounting policies under HKAS 39	27	(485)	-	(485)	-	-	-	(556)	-
Total equity at 1 January, after prior year and opening balance adjustments	27	425,139	167	425,306	387,317	160	387,477	422,821	385,746
Fair value gains on available-for-sale securities									
Net gains recognised directly in equity	27	87	-	87	-	-	-	-	-
Net losses transferred to income and expenditure account on disposal	27	7	-	7	-	-	-	-	-
		94	-	94	-	-	-	-	-
Surplus for the year									
As previously reported					39,203	-	39,203		38,527
Reclassification of minority interests to equity	3.1.1				-	21	21		-
Prior year adjustment arising from changes in accounting policies under HKAS 16 and 17	3.1.1				(896)	-	(896)		(896)
Surplus for the year (2004: as restated)	27	20,689	23	20,712	38,307	21	38,328	20,325	37,631
Dividends paid to minority interests	27	-	(12)	(12)	-	(14)	(14)	-	-
Total equity at 31 December	27	445,922	178	446,100	425,624	167	425,791	443,146	423,377

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - CASH FLOW STATEMENT

for the year ended 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
Cash flows from operating activities					
Surplus before share of profit of associate		20,809	38,434	20,325	37,631
Adjustments for:					
Interest income	4(a)	(31,307)	(24,598)	(29,719)	(23,574)
Dividend income	4(a)	(5,165)	(4,556)	(5,430)	(4,573)
Net losses on disposal of available-for-sale securities	4(a)	7	-	-	-
Interest expense	4(b)	16,990	18,066	16,026	17,856
Depreciation and amortisation	4(c)	147	155	116	120
Elimination of exchange differences and other non-cash items		1,990	(1,062)	2,068	(1,117)
Interest received		31,478	24,487	29,889	23,435
Interest paid		(21,379)	(29,328)	(20,424)	(29,088)
Dividends received		5,156	4,512	5,156	4,512
Tax paid		(161)	(80)	-	-
		18,565	26,030	18,007	25,202
Change in placements with banks and other financial institutions		12	3,995	3	4,015
Change in fair value of derivatives and other debt securities issued		(2,310)	-	(2,324)	-
Change in financial assets designated at fair value through profit or loss		40,740	-	40,740	-
Change in other investments in securities		-	(57,567)	-	(57,567)
Change in mortgage loans		5,739	(389)	-	-
Change in gold		(38)	(11)	(38)	(11)
Change in other assets		(5,439)	(276)	(5,329)	(227)
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		2,487	12,614	2,487	12,614
Change in balance of the banking system		(14,228)	(12,488)	(14,228)	(12,488)
Change in trading liabilities		5,820	-	5,820	-
Change in placements by banks and other financial institutions		(13,362)	(5,455)	(13,362)	(5,455)
Change in placements by other Hong Kong Special Administrative Region government funds		16,995	27,795	16,995	27,795
Change in placements by Hong Kong statutory bodies		-	(164)	-	(164)
Change in Exchange Fund Bills and Notes issued		(4,951)	2,340	(4,951)	2,340
Change in other liabilities		1,594	2,592	734	(1,913)
Net cash from/(used in) operating activities		51,624	(984)	44,554	(5,859)

EXCHANGE FUND - CASH FLOW STATEMENT (cont.)

for the year ended 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
Cash flows from investing activities					
Proceeds from sale of available-for-sale securities		2,217	–	–	–
Purchase of available-for-sale securities		(4,287)	–	(193)	–
Proceeds from sale or redemption of held-to-maturity securities		5,644	1,198	–	–
Purchase of held-to-maturity securities		(6,125)	(1,762)	–	–
Purchase of property, plant and equipment and intangible assets		(69)	(52)	(25)	(25)
Dividends received from subsidiaries		–	–	265	17
Net cash from/(used in) investing activities		(2,620)	(616)	47	(8)
Cash flows from financing activities					
Proceeds from issue of other debt securities		5,091	11,409	–	–
Redemption of other debt securities issued		(12,348)	(12,524)	–	–
Dividends paid to minority shareholders		(12)	(14)	–	–
Net cash used in financing activities		(7,269)	(1,129)	–	–
Net increase/(decrease) in cash and cash equivalents		41,735	(2,729)	44,601	(5,867)
Cash and cash equivalents at 1 January		178,852	180,469	173,420	178,170
Effect of foreign exchange rate changes		(2,065)	1,112	(2,068)	1,117
Cash and cash equivalents at 31 December	28	218,522	178,852	215,953	173,420

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - NOTES ON THE ACCOUNTS

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

1. Principal Activities

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance. The principal activities of the Fund are safeguarding the exchange value of the currency of Hong Kong and maintaining the stability and integrity of Hong Kong's monetary and financial systems. The consolidated financial statements of the Group comprise the Fund, its subsidiaries and its interest in an associate.

The principal activities of the subsidiaries and the associate are shown in notes 15 and 16.

The assets of the Fund are managed as two distinct portfolios: the Backing Portfolio and the Investment Portfolio. The assets of the Backing Portfolio fully match the Monetary Base, under Hong Kong's Currency Board system. The balance of the Fund's assets constitutes the Investment Portfolio. Segment information is set out in note 29.

2. Significant Accounting Policies

2.1 Statement of compliance

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which collective term includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs) and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), and accounting principles generally accepted in Hong Kong. A summary of the significant accounting policies adopted by the Group is set out below.

The HKICPA has issued a number of new and revised HKFRSs that are effective or available for early adoption for accounting periods beginning on or after 1 January 2005 (note 38). Information on the changes in accounting policies resulting from initial application of these new and revised HKFRSs for the current and prior accounting periods reflected in these financial statements is provided in note 3.

2.2 Basis of preparation of the financial statements

The measurement basis used in the preparation of the financial statements is historical cost except that the following assets and liabilities are stated at their fair value as explained in the accounting policies set out below:

- trading financial instruments (note 2.5.2.1);
- financial assets and financial liabilities designated at fair value through profit or loss (note 2.5.2.2);
- available-for-sale securities (note 2.5.2.5); and
- gold (note 2.10).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Note 36 contains information about the assumptions and risk factors relating to fair value of financial instruments. There are no critical accounting judgements involved in the application of the Group's accounting policies.

2.3 Subsidiaries

A subsidiary is an entity in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half the voting power or controls the composition of the board of directors. Subsidiaries are considered to be controlled if the Fund has the power, directly or indirectly, to govern the financial and operating policies, so as to obtain benefits from their activities.

Special Purpose Entities (SPEs) as disclosed in note 34 established in prior years in connection with securitisation programmes are not consolidated as they do not meet the definition of subsidiary in the Hong Kong Companies Ordinance.

An investment in a subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases.

Intra-group balances and transactions and any unrealised profits and losses arising from intra-group transactions are eliminated in full in preparing the consolidated financial statements.

Minority interests at the balance sheet date, being the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Fund, are presented in the consolidated balance sheet and statement of changes in equity within equity, separately from equity attributable to the owner of the Fund. Minority interests in the results of the Group are presented on the face of the consolidated income and expenditure account as an allocation of the surplus for the year between minority interests and the owner of the Fund.

In the Fund's balance sheet, its investments in subsidiaries are stated at cost less impairment losses, if any (note 2.14).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.4 Associate

An associate is an entity over which the Fund has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

An investment in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income and expenditure account includes the Group's share of the post-tax results of the associate for the year.

Unrealised profits and losses resulting from transactions between the Group and its associate are eliminated to the extent of the Group's interest in the associate.

In the Fund's balance sheet, its investment in an associate is stated at cost less impairment losses, if any (note 2.14).

2.5 Financial assets and financial liabilities

2.5.1 Initial recognition

The Group classifies its financial assets and financial liabilities into different categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred. The categories are: trading financial instruments, financial assets and financial liabilities designated at fair value through profit or loss, loans and receivables, held-to-maturity securities, available-for-sale securities and other financial liabilities.

A reconciliation of the categories of financial assets and financial liabilities to the balance sheet captions is set out in note 5.

Financial assets and financial liabilities are measured initially at fair value, which normally will be equal to the transaction prices, plus transaction costs for loans and receivables, held-to-maturity securities, available-for-sale securities and other financial liabilities that are directly attributable to the acquisition of the financial asset or issue of the financial liability. Transaction costs on trading financial instruments and financial assets and financial liabilities designated at fair value through profit or loss are expensed immediately.

The Group recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instrument. Purchases or sales of derivative financial instruments are recognised using trade date accounting. Purchases or sales of trading liabilities and financial assets designated at fair value through profit or loss, which are settled within the time frame established generally by regulation or convention in the market place concerned, are also recognised using trade date accounting. From this date, any gains and losses arising from changes in fair value are recorded. Other financial assets and financial liabilities are not subject to short term price fluctuations, and are therefore recognised using settlement date accounting.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.5.2 Categorisation

2.5.2.1 Trading financial instruments

The Group does not engage in active trading of financial instruments. However, derivative financial instruments that do not qualify for hedge accounting (note 2.8) and short positions in Exchange Fund Bills and Notes (EFBN) are categorised as “trading” under HKAS 39, “Financial Instruments: Recognition and Measurement”.

Trading financial instruments are carried at fair value. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

2.5.2.2 Financial assets and financial liabilities designated at fair value through profit or loss

Financial assets and financial liabilities designated at fair value through profit or loss primarily consist of:

- financial assets and financial liabilities that do not qualify for hedge accounting but are managed and whose performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy; and
- debt securities issued by the Fund’s subsidiary, The Hong Kong Mortgage Corporation Limited (HKMC), which include embedded derivatives where the characteristics and risks of the embedded derivatives are not closely related to the host contracts.

Financial assets and financial liabilities under this category are carried at fair value. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

2.5.2.3 Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and which the Group has no intention of trading, other than those that the Group, upon initial recognition, designates as at fair value through profit or loss or as available for sale. This category includes placements with banks and other financial institutions, cash and money at call, and mortgage loans purchased by the HKMC.

Loans and receivables are carried at amortised cost using the effective interest method less impairment losses, if any (note 2.9).

2.5.2.4 Held-to-maturity securities

Held-to-maturity securities are non-derivative financial assets with fixed or determinable payments and fixed maturity which the Group has the positive intention and ability to hold to maturity, other than (a) those that the Group, upon initial recognition, designates as at fair value through profit or loss or as available for sale; and (b) those that meet the definition of loans and receivables.

Held-to-maturity securities are carried at amortised cost using the effective interest method less impairment losses, if any (note 2.9).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

[Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.]

2.5.2.5 Available-for-sale securities

Available-for-sale securities are non-derivative securities that are designated as available for sale or are not classified in any of the other categories above. They include securities intended to be held for an indefinite period of time, but which may be sold in response to needs for liquidity or changes in the market environment.

Available-for-sale securities are carried at fair value. Unrealised gains and losses arising from changes in the fair value are recognised directly in the revaluation reserve, except for foreign exchange gains and losses which are recognised in the income and expenditure account.

The investment by the Fund in shares of the Bank for International Settlements is held on a long term basis for strategic purposes. As these shares do not have a quoted market price in an active market and the fair value cannot be reliably measured, they are carried at cost less impairment losses, if any (note 2.9).

When available-for-sale securities are sold, gains or losses on disposal include the difference between the net sale proceeds and the carrying amount, together with the accumulated fair value adjustments which are released from equity to the income and expenditure account.

2.5.2.6 Certificates of Indebtedness and government-issued currency notes and coins in circulation

As backing for the banknote issues, each note-issuing bank is required to hold a non-interest-bearing Certificate of Indebtedness issued by the Financial Secretary, which is redeemable on demand. Payments for the issue and redemption of banknotes against these Certificates are made in US dollars at the fixed exchange rate of US\$1=HK\$7.80. Consistent with the requirement for backing banknote issue with US dollars, the issue and the withdrawal of government-issued currency notes and coins are conducted with an agent bank against US dollars at the fixed exchange rate of US\$1=HK\$7.80.

The Group's liabilities in respect of Certificates of Indebtedness represent the US dollars payable to the note-issuing banks on redemption of the Certificates. The Group's liabilities in respect of government-issued currency notes and coins represent the US dollars payable to the agent bank when they are redeemed. Certificates of Indebtedness in issue and government-issued currency notes and coins in circulation are stated in the financial statements at the Hong Kong dollar equivalent of the US dollars required for their redemption at the exchange rate ruling at the balance sheet date.

2.5.2.7 Other financial liabilities

Other financial liabilities are financial liabilities other than trading liabilities and those designated at fair value through profit or loss.

Other financial liabilities with a fixed maturity are measured at amortised cost using the effective interest method. These include placements by banks and other financial institutions, placements by other HKSAR government funds with fixed maturity and certain debt securities (other than those which contain embedded derivatives) issued by the HKMC.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Other financial liabilities repayable on demand are stated at the principal amount payable. These include placements by other HKSAR government funds which are repayable on demand and the balance of the banking system.

2.5.3 Fair value measurement principles

The fair value of financial instruments is based on their quoted market prices at the balance sheet date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices.

If there is no publicly available latest traded price nor a quoted market price on a recognised stock exchange or a price from a broker/dealer for non-exchange-traded financial instruments, or if the market for it is not active, the fair value of the financial asset or financial liability is estimated using valuation techniques that provide a reliable estimate of prices which could be obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market rate at the balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date.

2.5.4 Derecognition

A financial asset is derecognised when the contractual rights to receive the cash flows from the financial asset expire, or where the financial asset together with substantially all the risks and rewards of ownership, have been transferred.

The Group uses the weighted average method to determine realised gains and losses to be recognised in profit or loss on derecognition.

A financial liability is derecognised when the obligation specified in the contract is discharged, cancelled or expires.

Liabilities for EFBN in issue are derecognised when they are repurchased as a result of market making activities as the repurchase is considered a redemption of the debt.

2.5.5 Offsetting

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet where there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

2.5.6 Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that includes both the derivative and a host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Embedded derivatives are separated from the host contract and accounted for as a derivative when (a) the economic characteristics and risks of the embedded derivative are not closely related to the host contract; and (b) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the income and expenditure account. Where the embedded derivative is separated, the host contract is accounted for according to its category (note 2.5.2).

The early call options embedded in the debt securities issued by the HKMC are not separated as the entire hybrid (combined) contracts are accounted for as financial liabilities designated at fair value through profit or loss (note 2.5.2.2).

2.6 Repurchase and reverse repurchase transactions

Securities sold subject to a simultaneous agreement to repurchase these securities at a certain later date at a fixed price (repurchase agreements) are retained on the balance sheet and measured in accordance with their original measurement principles. The proceeds of the sale are reported as liabilities in “placements by banks and other financial institutions” and are carried at amortised cost.

Conversely, securities purchased under agreements to resell (reverse repurchase agreements) are reported not as purchases of the securities, but as receivables in “placements with banks and other financial institutions” and are carried in the balance sheet at amortised cost.

Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements is recognised as interest income or interest expense, over the life of each agreement using the effective interest method.

2.7 Securities lending agreements

Where securities are loaned with the receipt of cash or securities as collateral, they are retained on the balance sheet and measured in accordance with their original measurement principles. Where cash collateral is received, a liability is recorded in respect of the cash received in “placements by banks and other financial institutions”.

2.8 Hedging

Hedge accounting recognises the offsetting effects on income and expenditure of changes in the fair values of the hedging instrument and the hedged item.

The Group adopts hedge accounting for derivatives used in hedges of exposures to changes in fair values of certain fixed rate debt securities issued by the HKMC (fair value hedges). The Group assesses and documents whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged liabilities attributable to the hedged risks both at hedge inception and on an ongoing basis. The Group discontinues prospectively hedge accounting when (a) the hedging instrument expires or is sold, terminated or exercised; (b) the hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes the designation.

Derivatives that qualify as fair value hedges are measured at fair value, with fair value changes recognised in the income and expenditure account, together with any changes in the fair value of the hedged item attributable to the risk being hedged.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.9 Impairment of financial assets

The carrying amount of loans and receivables, held-to-maturity securities and available-for-sale securities are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. For loans and receivables and held-to-maturity securities, if any such evidence exists, an impairment loss is recognised in the income and expenditure account as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If in a subsequent period the amount of such impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income and expenditure account.

For available-for-sale securities carried at fair value, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the income and expenditure account. Such impairment losses are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses for debt securities are recognised in the income and expenditure account. Reversals of impairment losses for equity securities are recognised directly in equity.

For available-for-sale equity securities carried at cost, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar instrument. Such impairment losses are not reversed.

2.10 Gold

Gold is carried at market value. Changes in the market value of gold are included in the income and expenditure account in the period in which they arise.

2.11 Property, plant and equipment

The following items of property, plant and equipment are stated in the balance sheet at cost less accumulated depreciation and any impairment losses (note 2.14):

- a building held for own use situated on freehold land;
- a building held for own use situated on leasehold land, where the fair value of the leasehold interest in the land and building could be measured separately at the inception of the lease. The land element is treated as an operating land lease prepayment (note 2.12); and
- plant and equipment, including plant, machinery, furniture, fixtures, equipment, motor vehicles and personal computers.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

Depreciation is calculated to write off the cost of items of property, plant and equipment on a straight line basis over the estimated useful lives as follows:

- Freehold land is not depreciated.
- Building situated on freehold land 39 years
- Buildings situated on leasehold land are depreciated over the shorter of the unexpired term of lease and their estimated useful lives.
- Plant and equipment 2 – 15 years

Subsequent expenditure relating to an item of property, plant and equipment that has already been recognised is added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the Group. All other subsequent expenditure is recognised as an expense in the period in which it is incurred.

Gain or loss arising from the disposal of an item of property, plant and equipment is determined as the difference between the net disposal proceeds and the carrying amount of the asset and is recognised in the income and expenditure account.

2.12 Operating land lease prepayment

Operating land lease prepayment is the land element of the payment for a building held for own use situated on leasehold land, the fair value of which could be measured separately from the fair value of the building at the inception of the lease. The valuation was carried out by an independent professional valuer who estimated the value of the building element using the “net replacement cost” method and took the residual figure as the value of the land element. The land element, accounted for as an operating lease, is stated in the balance sheet at cost less accumulated depreciation and any impairment losses (note 2.14). The land element is depreciated on a straight-line basis over the unexpired term of the lease.

2.13 Intangible assets

Intangible assets include acquired computer software licences and capitalised development costs of computer software programmes. Expenditure on development of computer software programmes is capitalised if the programmes are technically and commercially feasible and the Group has sufficient resources and the intention to complete development. The expenditure capitalised includes the direct labour and costs of materials. Intangible assets are stated at cost less accumulated amortisation and any impairment losses (note 2.14).

Amortisation of intangible assets is charged to the income and expenditure account on a straight-line basis over the assets’ estimated useful lives of 3 to 5 years.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.14 Impairment of other assets

The carrying amount of other assets, including investments in subsidiaries, investment in associate, property, plant and equipment and intangible assets, are reviewed at each balance sheet date to identify any indication of impairment.

If any such indication exists, an impairment loss is recognised in the income and expenditure account whenever the carrying amount of an asset exceeds its recoverable amount. The recoverable amount of an asset is the greater of its net selling price and value in use.

2.15 Cash equivalents

Cash equivalents include money at call, placements with banks and other financial institutions and short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant risk of changes in value, having been within three months of maturity when placed or acquired.

2.16 Revenue and expenditure recognition**2.16.1 Interest income and expense**

Interest on the majority of the placements by other HKSAR government funds is payable at rates determined by reference to the investment income of the Fund. Interest on these placements is recognised monthly in the income and expenditure account on an accrual basis, based on the investment income of the Fund for the month.

Interest income and expense for all other interest-bearing financial assets and financial liabilities is recognised in the income and expenditure account on an accrual basis, using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instruments (for example, prepayment options) but does not consider future credit losses. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

For impaired mortgage loans, the accrual of interest income based on the original terms of the loan is discontinued, but any increase in the present value of impaired loans due to the passage of time is reported as interest income.

2.16.2 Net realised and revaluation gains

Realised gains or losses on financial instruments are recognised in the income and expenditure account when the financial instruments are derecognised.

Changes in fair value of trading financial instruments and financial assets and financial liabilities designated at fair value through profit or loss are recognised as revaluation gains or losses in the income and expenditure account.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.16.3 Dividend and other income

Dividend income from listed equity securities is recognised when the share price is quoted ex-dividend. Dividend income from unlisted equity securities is recognised when the shareholder's right to receive payment is established.

Bank licence fees are fees receivable from authorized institutions under the Banking Ordinance and are accounted for in the period when receivable.

Other income includes income from the sale of withdrawn coins and Central Moneymarkets Unit fee income. Other income is accounted for in the period when receivable.

2.16.4 Contributions to staff retirement schemes

The Group operates several defined contribution schemes, including the Mandatory Provident Fund Scheme. Under these schemes, contributions payable each year are charged to the income and expenditure account. The assets of the staff retirement schemes are held separately from those of the Group.

2.16.5 Rental payments under operating leases

Leases where substantially all the rewards and risks of ownership remain with the leasing company are classified as operating leases. Rental payments made under operating leases are charged to the income and expenditure account on a straight-line basis over the period of the relevant leases.

2.16.6 Income tax

The Fund is exempt from income tax. Income tax payable on profits of subsidiaries is recognised as an expense in the period in which profits arise.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the asset can be utilised. Deferred tax liabilities are provided in full.

2.17 Foreign currency translation

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the exchange rates ruling at the balance sheet date.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates. Non-monetary assets and liabilities that are measured at fair value are translated into Hong Kong dollars using the exchange rates at the dates when the fair value was determined.

All exchange differences are presented in aggregate as "net exchange gains/(losses)" in the income and expenditure account. Although it is not practicable to disclose separately the net exchange gains/(losses) on financial assets and financial liabilities designated at fair value through profit or loss or on trading financial instruments, the majority of the exchange gains/(losses) relate to these two categories of financial instruments.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

2.18 Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals or entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals.

2.19 Segment reporting

The activities of the Fund managed by the Hong Kong Monetary Authority (HKMA) comprise the following business segments:

- Management of funds under the Currency Board Operations;
- Management of funds representing the general reserve assets of the Fund; and
- Maintaining the stability and integrity of financial and banking system of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

Details are set out in note 29. There is no disclosure of geographic segments as the Group operates predominantly in Hong Kong.

In line with the normal practice of central banking institutions, no further breakdown of the Group's investments by currencies or geographic markets is disclosed.

3. CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued a number of new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2005.

The accounting policies of the Group and/or the Fund after the adoption of these new and revised HKFRSs have been summarised in note 2. The following sets out information on the significant changes in accounting policies for the current and prior accounting periods reflected in these financial statements.

Except for two amendments to HKAS 39, the Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (note 38).

3.1 Restatement of prior period and opening balances

The following tables disclose the adjustments that have been made in accordance with the transitional provisions of the respective HKFRSs to each of the line items in the income and expenditure account and balance sheet as previously reported for the year ended 31 December 2004. The effects of the changes in accounting policies on equity at 1 January 2004 and 2005 are disclosed in note 27.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

3.1.1 Effect on the income and expenditure account for the year ended 31 December 2004

	2004 (as previously reported)	Group		2004 (restated)
		Effect of new policy (increase/(decrease) in surplus for the year)		
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)	
INCOME				
Interest income	24,598	-	-	24,598
Dividend income	4,556	-	-	4,556
Net realised and revaluation gains	20,120	-	-	20,120
Net exchange gains	8,469	-	-	8,469
Bank licence fees	129	-	-	129
Other income	353	-	-	353
TOTAL INCOME	58,225	-	-	58,225
EXPENDITURE				
Interest expense	(18,066)	-	-	(18,066)
Operating expenses	(1,523)	89	(20)	(1,454)
Note and coin expenses	(182)	-	-	(182)
Provisions made for bad and doubtful loans	-	(89)	-	(89)
TOTAL EXPENDITURE	(19,771)	-	(20)	(19,791)
SURPLUS BEFORE PREMISES REVALUATION AND SHARE OF PROFIT OF ASSOCIATE	38,454	-	(20)	38,434
Surplus on revaluation of premises	876	-	(876)	-
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	39,330	-	(896)	38,434
Share of profit of associate	4	(1)	-	3
SURPLUS BEFORE TAXATION	39,334	(1)	(896)	38,437
Income tax	(110)	1	-	(109)
SURPLUS AFTER TAXATION	39,224	-	(896)	38,328
Minority interests	(21)	21	-	-
SURPLUS FOR THE YEAR	39,203	21	(896)	38,328
ATTRIBUTABLE TO:				
Owner of the Fund	39,203	-	(896)	38,307
Minority interests	-	21	-	21
	39,203	21	(896)	38,328

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	2004 (as previously reported)	Fund Effect of new policy (increase/ (decrease) in surplus for the year)	2004 (restated)
	HKAS 16 & 17 (note 3.5)		
INCOME			
Interest income	23,574	–	23,574
Dividend income	4,573	–	4,573
Net realised and revaluation gains	20,120	–	20,120
Net exchange gains	8,474	–	8,474
Bank licence fees	129	–	129
Other income	70	–	70
TOTAL INCOME	56,940	–	56,940
EXPENDITURE			
Interest expense	(17,856)	–	(17,856)
Operating expenses	(1,251)	(20)	(1,271)
Note and coin expenses	(182)	–	(182)
TOTAL EXPENDITURE	(19,289)	(20)	(19,309)
SURPLUS BEFORE PREMISES REVALUATION	37,651	(20)	37,631
Surplus on revaluation of premises	876	(876)	–
SURPLUS FOR THE YEAR ATTRIBUTABLE TO OWNER OF THE FUND	38,527	(896)	37,631

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

3.1.2 Effect on the balance sheet at 31 December 2004 and 1 January 2005

	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)		2004 (restated)	Group		Opening balance at 1 January 2005
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)		HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	
ASSETS							
Cash and money at call	20,759	-	-	20,759	-	-	20,759
Placements with banks and other financial institutions	48,178	-	-	48,178	-	3	48,181
Derivative financial instruments	-	1,438	-	1,438	-	876	2,314
Financial assets designated at fair value through profit or loss	-	-	-	-	977,416	(544)	976,872
Other investments in securities	977,746	-	-	977,746	(976,431)	(1,315)	-
Available-for-sale securities	-	-	-	-	300	-	300
Investment securities	300	-	-	300	(300)	-	-
Held-to-maturity securities	4,130	-	-	4,130	-	-	4,130
Mortgage loans	34,938	-	-	34,938	-	54	34,992
Gold	228	-	-	228	-	-	228
Other assets	14,510	(1,112)	-	13,398	(985)	(568)	11,845
Investment in associate	23	-	-	23	-	-	23
Fixed assets	4,286	(4,286)	-	-	-	-	-
Property, plant and equipment	-	4,244	(3,359)	885	-	-	885
Operating land lease prepayment	-	-	3,145	3,145	-	-	3,145
Intangible assets	-	42	-	42	-	-	42
TOTAL ASSETS	1,105,098	326	(214)	1,105,210	-	(1,494)	1,103,716

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)	2004 (restated)	Group HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	Opening balance at 1 January 2005	
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)				
LIABILITIES AND EQUITY							
Certificates of Indebtedness	146,775	-	-	146,775	-	(514)	146,261
Government-issued currency notes and coins in circulation	6,351	-	-	6,351	-	(22)	6,329
Balance of the banking system	15,789	-	-	15,789	-	-	15,789
Derivative financial instruments	-	2,372	-	2,372	-	14	2,386
Trading liabilities	-	100	-	100	-	1,491	1,591
Placements by banks and other financial institutions	39,087	-	-	39,087	-	(13)	39,074
Placements by other HKSAR government funds	280,091	-	-	280,091	-	-	280,091
Exchange Fund Bills and Notes issued	125,860	-	-	125,860	-	(2,775)	123,085
Other debt securities issued	35,495	-	-	35,495	-	830	36,325
Other liabilities	29,645	(2,146)	-	27,499	-	(20)	27,479
Total liabilities	679,093	326	-	679,419	-	(1,009)	678,410
Accumulated surplus	425,644	-	(20)	425,624	-	(485)	425,139
Premises revaluation reserve	194	-	(194)	-	-	-	-
Total equity attributable to owner of the Fund	425,838	-	(214)	425,624	-	(485)	425,139
Minority interests	-	167	-	167	-	-	167
Total equity	425,838	167	(214)	425,791	-	(485)	425,306
Minority interests	167	(167)	-	-	-	-	-
TOTAL LIABILITIES AND EQUITY	1,105,098	326	(214)	1,105,210	-	(1,494)	1,103,716

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)		Fund 2004 (restated)	HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	Opening balance at 1 January 2005
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)				
ASSETS							
Cash and money at call	20,738	-	-	20,738	-	-	20,738
Placements with banks and other financial institutions	42,747	-	-	42,747	-	3	42,750
Derivative financial instruments	-	1,438	-	1,438	-	-	1,438
Financial assets designated at fair value through profit or loss	-	-	-	-	977,416	(544)	976,872
Other investments in securities	977,746	-	-	977,746	(976,431)	(1,315)	-
Available-for-sale securities	-	-	-	-	300	-	300
Investment securities	300	-	-	300	(300)	-	-
Gold	228	-	-	228	-	-	228
Other assets	13,914	(1,438)	-	12,476	(985)	(568)	10,923
Investments in subsidiaries	2,145	-	-	2,145	-	-	2,145
Fixed assets	4,036	(4,036)	-	-	-	-	-
Property, plant and equipment	-	3,994	(3,359)	635	-	-	635
Operating land lease prepayment	-	-	3,145	3,145	-	-	3,145
Intangible assets	-	42	-	42	-	-	42
TOTAL ASSETS	1,061,854	-	(214)	1,061,640	-	(2,424)	1,059,216
LIABILITIES AND EQUITY							
Certificates of Indebtedness	146,775	-	-	146,775	-	(514)	146,261
Government-issued currency notes and coins in circulation	6,351	-	-	6,351	-	(22)	6,329
Balance of the banking system	15,789	-	-	15,789	-	-	15,789
Derivative financial instruments	-	2,372	-	2,372	-	-	2,372
Trading liabilities	-	100	-	100	-	1,491	1,591
Placements by banks and other financial institutions	39,087	-	-	39,087	-	(13)	39,074
Placements by other HKSAR government funds	280,091	-	-	280,091	-	-	280,091
Exchange Fund Bills and Notes issued	125,860	-	-	125,860	-	(2,775)	123,085
Other liabilities	24,310	(2,472)	-	21,838	-	(35)	21,803
Total liabilities	638,263	-	-	638,263	-	(1,868)	636,395
Accumulated surplus	423,397	-	(20)	423,377	-	(556)	422,821
Premises revaluation reserve	194	-	(194)	-	-	-	-
Total equity	423,591	-	(214)	423,377	-	(556)	422,821
TOTAL LIABILITIES AND EQUITY	1,061,854	-	(214)	1,061,640	-	(2,424)	1,059,216

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

3.2 Estimated effect of changes in accounting policies on the current period

In respect of the year ended 31 December 2005, it is considered impractical to determine the extent to which the surplus for the year and the net assets would have been higher or lower had the previous accounting policies still been applied.

3.3 Financial instruments (HKAS 39, Financial instruments)

With effect from 1 January 2005, in order to comply with HKAS 32, the Group has provided additional disclosures of terms, conditions, accounting policies, risk and fair values of financial assets and financial liabilities throughout the notes to the financial statements and in the specific notes 35 and 36. In order to comply with HKAS 39, the Group has changed its accounting policies relating to financial assets and financial liabilities to those set out in notes 2.5 to 2.9. In prior years, some financial assets and financial liabilities were carried at cost or amortised cost, net of provisions, while some were held at fair value. With effect from 1 January 2005, and in accordance with HKAS 39, financial assets and financial liabilities are recognised according to the following categories: trading financial instruments, financial assets and financial liabilities designated at fair value through profit or loss, loans and receivables, held-to-maturity securities, available-for-sale securities and other financial liabilities as set out in note 2.5.2. Further details of the changes are as follows:

(a) Investments in securities

In prior years, investments in securities were classified into:

- other investments in securities, which were carried at fair value with changes in fair value recognised in the income and expenditure account;
- investment securities, which were carried at cost less provision for diminution in value which is other than temporary; and
- held-to-maturity securities, which were carried at amortised cost less provision for diminution in value.

On 1 January 2005, in order to comply with HKAS 39, the first two categories were re-designated into the following categories with the same measurement principles:

- other investments in securities were re-designated as financial assets designated at fair value through profit or loss (note 2.5.2.2); and
- investment in shares of the Bank for International Settlements previously classified as investment securities was re-designated as an available-for-sale security carried at cost (note 2.5.2.5).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Placements with banks and other financial institutions

In prior years, placements with banks and other financial institutions were carried in the balance sheet at fair value. Changes in fair value were recognised in the income and expenditure account.

With effect from 1 January 2005, placements with banks and other financial institutions are carried at amortised cost using the effective interest method, less impairment losses, if any (note 2.5.2.3).

(c) Certificates of Indebtedness and government-issued currency notes and coins in circulation

In prior years, Certificates of Indebtedness and government-issued currency notes and coins in circulation were stated in the financial statements at their Hong Kong dollar face value. At the balance sheet date, the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption was included in "other assets" (note 14). With effect from 1 January 2005, in order to comply with HKAS 39, they are stated in the financial statements at amortised cost, which is the Hong Kong dollar equivalent of the US dollars required for their redemption at the exchange rate ruling at the balance sheet date (note 2.5.2.6).

(d) Placements by banks and other financial institutions and other HKSAR government funds

In prior years, placements by banks and other financial institutions and other HKSAR government funds with interest payable based on market rates were valued at fair value. With effect from 1 January 2005, in order to comply with HKAS 39, such fixed maturity placements are carried at amortised cost using the effective interest method, while such placements repayable on demand are stated at the principal amount payable (note 2.5.2.7).

(e) Exchange Fund Bills and Notes

In prior years, long and short positions of EFBN held by the Fund were shown separately from EFBN in issue as assets and liabilities of the Fund. With effect from 1 January 2005, EFBN in issue are derecognised when repurchased by the Fund (note 2.5.4) and short positions taken are categorised as trading liabilities (note 2.5.2.1).

(f) Fair value measurement principles

In prior years, quoted equity securities carried at fair value were priced at closing market prices. Debt securities carried at fair value were priced at mid market prices. With effect from 1 January 2005, financial assets are priced at current bid prices.

In prior years, short positions in debt securities were valued at mid market prices. With effect from 1 January 2005, financial liabilities are priced at current asking prices.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(g) Derivatives and hedge accounting

Derivatives used for investment management

In prior years, transactions undertaken for investment management purposes were marked to market and the revaluation gain or loss was recognised in the income and expenditure account as “net exchange gains/(losses)” for currency derivatives or “other net realised and revaluation gains/(losses)” for other derivatives, and included in the balance sheet as “other assets” or “other liabilities” as appropriate.

Derivatives used for hedging purposes

In prior years, interest rate swaps entered into as a hedge were valued on an equivalent basis to the underlying assets or liabilities which they were hedging. Net interest payable or receivable arising from interest rate swaps was recognised on an accrual basis and charged against interest income or interest expense on the related assets or liabilities.

Any gain or loss on termination of the interest rate swap was deferred and amortised over the remaining original life of the terminated contract. Where the underlying asset or liability was sold or terminated, the hedging interest rate swap was immediately marked to market through the income and expenditure account.

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies relating to derivatives and hedge accounting to those set out in notes 2.5.2.1 and 2.8.

(h) Embedded derivatives

In prior years, embedded derivatives were not separately accounted for and they were carried as part of the host contracts.

With effect from 1 January 2005, an embedded derivative that is not closely related to the host contract and where the hybrid (combined) instrument is not measured at fair value through profit or loss is accounted for separately from the host contract (note 2.5.6).

(i) Impairment of financial assets

Loans and advances

In prior years, provisions were made by the HKMC against mortgage loans in accordance with the approved guidelines. General provision related to non-performing exposures not separately identified but known from experience to exist in the mortgage portfolio. Specific provision for bad and doubtful loans generally applied to a mortgage loan that was overdue for more than 90 days, or in case of a mortgage loan which had been rescheduled under the relief plans, where extension of repayment holiday and/or reduction in repayment amount had been granted to the borrower. The specific provision was based on certain percentages of the difference between the current market value or the forced sale value of the underlying property and the outstanding principal balance of the mortgage loan. The percentages were validated annually with reference to the delinquency migration pattern of the mortgage portfolio.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies relating to impairment on mortgage loans to those set out in note 2.9.

(j) Interest recognition on impaired mortgage loans

In prior years, the accrual of interest on mortgage loans was discontinued when they became overdue for 90 days or more. Interest income on the overdue loans was only recognised when all arrears of principal and interest from the borrowers had been cleared and it was probable that the customer was capable of fully servicing his obligations under the terms of the loans for the foreseeable future.

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies and continues to recognise interest income on impaired mortgage loans (note 2.16.1).

(k) Description of transitional provisions and effect of adjustments

The changes in accounting policies of the above items were adopted by way of opening balance adjustments to certain reserves and re-designation of financial instruments as at 1 January 2005 as disclosed in the respective note. Comparative figures have not been restated as this is prohibited by the transitional arrangements in HKAS 39.

The respective adjustments for each financial statement line of the Group and of the Fund affected for the year ended 31 December 2004 and as at 31 December 2004 and 1 January 2005 are set out in notes 3.1.1 and 3.1.2.

3.4 Changes in presentation (HKAS 1, Presentation of financial statements)

(a) Presentation of income and expenditure account and balance sheet

With effect from 1 January 2005, in order to take into account the measurement basis that has been applied, the Group has changed its presentation of certain items on the face of the income and expenditure account and balance sheet. Provisions for bad and doubtful loans are reclassified from "operating expenses" and presented separately as "impairment losses on loans". Fixed assets are split between "property, plant and equipment", "operating land lease prepayment" and "intangible assets". Derivative financial instruments and trading liabilities are reclassified from "other assets" or "other liabilities" and presented separately.

(b) Presentation of share of associate's taxation (HKAS 1, Presentation of financial statements)

In prior years, the Group's share of taxation of associate accounted for using the equity method was included as part of the Group's income tax in the income and expenditure account. With effect from 1 January 2005, in accordance with the implementation guidance in HKAS 1, the Group has changed the presentation and includes the share of taxation of associate in the respective share of profit reported in the consolidated income and expenditure account before arriving at the Group's surplus before taxation.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

- (c) Presentation of minority interests (HKAS 1, Presentation of financial statements and HKAS 27, Consolidated and separate financial statements)

In prior years, minority interests were presented in the consolidated balance sheet separately from liabilities. Minority interests in the results of the Group for the year were also separately presented in the consolidated income and expenditure account as a deduction before arriving at the surplus for the year.

With effect from 1 January 2005, in order to comply with HKAS 1 and HKAS 27, the Group has changed its accounting policy relating to the presentation of minority interests. Under the new policy, minority interests are presented as part of equity, separately from interests attributable to owner of the Fund. Further details of the new policy are set out in note 2.3.

- (d) Intangible assets (HKAS1, Presentation of financial statements and HKAS 38, Intangible assets)

In prior years, computer software licences and capitalised development costs were classified as fixed assets. With effect from 1 January 2005, in order to comply with HKAS 1 and HKAS 38, the Group has changed the presentation and these items are now presented separately as “intangible assets” on the balance sheet.

- (e) Insurance contracts (HKAS 1, Presentation of financial statements and HKFRS 4, Insurance contracts)

In prior years, on consolidation of the HKMC, unearned insurance premium was shown on a net basis in the balance sheet. With effect from 1 January 2005, in order to comply with HKAS 1 and HKFRS 4, the Group has changed the presentation and shows insurance assets and the related insurance liabilities separately and included in “other assets” and “other liabilities” respectively.

These changes in presentation have been applied retrospectively with comparatives reclassified as shown in notes 3.1.1 and 3.1.2.

3.5 Leasehold land and buildings (HKAS 17, Leases and HKAS 16, Property, plant and equipment)

In prior years, leasehold land and buildings held for own use were stated at valuation less accumulated depreciation and accumulated impairment losses. Movements in revaluation surpluses or deficits were taken to the premises revaluation reserve.

With effect from 1 January 2005, in order to comply with HKAS 17, the Group has adopted a new policy for leasehold land and buildings held for own use. Under the new policy, the leasehold interest in the land is accounted for as being held under an operating lease where the fair value of the interest in the building situated on the leasehold land could be measured separately from the fair value of the leasehold land at the time the lease is entered into by the Group (note 2.12).

The building held for own use which is situated on such land leases continues to be presented as part of property, plant and equipment. However, as from 1 January 2005 the building is stated at cost less accumulated depreciation under HKAS 16, rather than at fair value, to be consistent with the new policy required to be adopted for the land element.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

All the above new accounting policies relating to leases have been adopted retrospectively. The adjustments for each financial statement line affected for the year ended 31 December 2004 are set out in note 3.1.1.

4. INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2005	2004	2005	2004
Interest income				
– from derivative financial instruments	374	684	374	684
– from financial assets designated at fair value through profit or loss	24,782	–	24,782	–
– from other financial assets	6,151	23,914	4,563	22,890
	31,307	24,598	29,719	23,574
Dividend income				
– from financial assets designated at fair value through profit or loss	5,157	–	5,157	–
– from other financial assets	8	4,556	8	4,556
– from subsidiaries	–	–	265	17
	5,165	4,556	5,430	4,573
Net realised and revaluation gains				
– on derivative financial instruments	398	370	1,484	370
– on financial assets and financial liabilities designated at fair value through profit or loss	21,782	–	20,698	–
– on other financial assets and financial liabilities	–	19,750	–	19,750
– on available-for-sale securities	(7)	–	–	–
	22,173	20,120	22,182	20,120
Net exchange gains/(losses)	(19,468)	8,469	(19,474)	8,474
TOTAL INVESTMENT INCOME	39,177	57,743	37,857	56,741

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Interest expense

	Group		Fund	
	2005	2004	2005	2004
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value through profit or loss and trading liabilities	3,273	–	3,182	–
Interest expense on other financial liabilities	13,717	18,066	12,844	17,856
TOTAL	16,990	18,066	16,026	17,856
Comprises:				
Interest on placements by other HKSAR government funds				
With interest at rates determined by reference to the investment income of the Fund	10,060	14,533	10,060	14,533
With interest at market-based rates	122	25	122	25
Interest on Exchange Fund Bills and Notes issued	3,061	2,558	3,061	2,558
Other interest expense	3,747	950	2,783	740
	16,990	18,066	16,026	17,856

(c) Operating expenses

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Staff costs				
Salaries and other staff costs	554	523	449	421
Retirement benefit costs	31	31	25	25
Premises and equipment expenses				
Depreciation and amortisation	147	155	116	120
Rental expense under operating leases	5	18	4	10
Other premises expenses	37	39	31	33
General operating costs				
Maintenance of office and computer equipment	33	35	27	30
Financial information and communication services	33	31	28	27
External relations	13	15	12	13
Professional and other services	31	43	23	35
Training	5	5	4	4
Others	3	12	13	10
Investment management and custodian fees	734	547	731	543
TOTAL	1,626	1,454	1,463	1,271

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

The aggregate emoluments of senior staff (Executive Directors and above) of the Group are as follows:

	Group	
	2005	2004
Fixed pay	47.8	45.9
Variable pay	11.9	7.8
Other benefits	4.4	4.2
	64.1	57.9

Other benefits shown above include provident funds, medical and life insurance, gratuity and annual leave accrued during the year. There are no other allowances or benefits-in-kind.

The number of senior staff (Executive Directors and above) of the Group whose emoluments fell within the following bands were:

HK\$	Group	
	2005	2004
500,000 or below	1	–
1,000,001 to 1,500,000	2	1
2,500,001 to 3,000,000	1	–
3,000,001 to 3,500,000	4	6
3,500,001 to 4,000,000	3	2
4,000,001 to 4,500,000	3	2
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	–	1
6,000,001 to 6,500,000	1	–
8,500,001 to 9,000,000	–	1
9,500,001 to 10,000,000	1	–
	17	14

(d) Note and coin expenses

These represent reimbursements to the note-issuing banks in respect of note-issuing expenses and expenses incurred directly by the Fund in issuing government-issued currency notes and coins.

(e) Impairment losses on loans/(Provisions made for bad and doubtful loans)

	Group		Fund	
	2005	2004	2005	2004
Write back of impairment losses on loans	19	–	–	–
Provisions made for bad and doubtful loans	–	[89]	–	–
TOTAL	19	[89]	–	–

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

5. CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

	Notes	Group – 2005						
		Total	Trading financial instruments	at fair value through profit or loss	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	15,937	-	-	15,937	-	-	-
Placements with banks and other financial institutions	7	75,648	-	-	75,648	-	-	-
Derivative financial instruments	8(a)	1,950	1,950	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9(a)	953,145	-	953,145	-	-	-	-
Available-for-sale securities	10(a)	2,483	-	-	-	-	2,483	-
Held-to-maturity securities	11	4,605	-	-	-	4,605	-	-
Mortgage loans	12	29,476	-	-	29,476	-	-	-
Other assets	14	17,015	-	-	17,015	-	-	-
FINANCIAL ASSETS		1,100,259	1,950	953,145	138,076	4,605	2,483	-
Certificates of Indebtedness	20	148,406	-	-	-	-	-	148,406
Government-issued currency notes and coins in circulation	20	6,671	-	-	-	-	-	6,671
Balance of the banking system	21	1,561	-	-	-	-	-	1,561
Derivative financial instruments	8(a)	834	834	-	-	-	-	-
Trading liabilities		7,412	7,412	-	-	-	-	-
Placements by banks and other financial institutions	22	25,712	-	-	-	-	-	25,712
Placements by other HKSAR government funds	23	297,086	-	-	-	-	-	297,086
Exchange Fund Bills and Notes issued	24	118,134	-	118,134	-	-	-	-
Other debt securities issued	25	27,991	-	2,600	-	-	-	25,391
Other liabilities	26	24,636	-	-	-	-	-	24,636
FINANCIAL LIABILITIES		658,443	8,246	120,734	-	-	-	529,463

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Notes	Fund - 2005						
		Total	Trading financial instruments	at fair value through profit or loss	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	15,887	-	-	15,887	-	-	-
Placements with banks and other financial institutions	7	73,120	-	-	73,120	-	-	-
Derivative financial instruments	8(a)	1,865	1,865	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9(a)	953,145	-	953,145	-	-	-	-
Available-for-sale securities	10(a)	493	-	-	-	-	493	-
Other assets	14	16,149	-	-	16,149	-	-	-
FINANCIAL ASSETS		1,060,659	1,865	953,145	105,156	-	493	-
Certificates of Indebtedness	20	148,406	-	-	-	-	-	148,406
Government-issued currency notes and coins in circulation	20	6,671	-	-	-	-	-	6,671
Balance of the banking system	21	1,561	-	-	-	-	-	1,561
Derivative financial instruments	8(a)	525	525	-	-	-	-	-
Trading liabilities		7,412	7,412	-	-	-	-	-
Placements by banks and other financial institutions	22	25,712	-	-	-	-	-	25,712
Placements by other HKSAR government funds	23	297,086	-	-	-	-	-	297,086
Exchange Fund Bills and Notes issued	24	118,134	-	118,134	-	-	-	-
Other liabilities	26	18,146	-	-	-	-	-	18,146
FINANCIAL LIABILITIES		623,653	7,937	118,134	-	-	-	497,582

6. CASH AND MONEY AT CALL

	Group		Fund	
	2005	2004	2005	2004
At amortised cost				
Balance with central banks	619	678	619	678
Balance with banks and other financial institutions	15,318	20,081	15,268	20,060
TOTAL	15,937	20,759	15,887	20,738

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

7. PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2005	2004	2005	2004
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	200	209	200	209
– with banks and other financial institutions	5,488	4,765	5,488	4,765
Other placements with banks and other financial institutions	69,960	43,204	67,432	37,773
TOTAL	75,648	48,178	73,120	42,747

8. DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments refer to financial contracts whose value depends on the value of one or more underlying assets or indices.

The Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies for the Fund. The principal derivative financial instruments used are interest rate and currency swap contracts, forward foreign exchange contracts, which are primarily over-the-counter derivatives, as well as exchange-traded futures contracts.

Market risk arising from derivative financial instruments is included as part of the Fund's overall market risk exposure. The credit risk arising from these transactions is marked against the Fund's overall credit exposure to individual counterparties. The risk management approaches of the Fund are outlined in note 35.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(a) Fair values of derivative financial instruments

Analysis of the fair values of derivative financial instruments held by product type is set out below:

	Group				Fund			
	2005		2004		2005		2004	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	454	110	1,159	-	421	32	1,159	-
Currency derivatives								
Forward foreign exchange contracts	1,441	411	278	2,341	1,441	410	278	2,341
Others								
Stock index futures contracts	3	82	1	30	3	82	1	30
Bond futures contracts	-	1	-	1	-	1	-	1
	1,898	604	1,438	2,372	1,865	525	1,438	2,372
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	52	229	-	-	-	-	-	-
Currency derivatives								
Currency swap contracts	-	1	-	-	-	-	-	-
	52	230	-	-	-	-	-	-
TOTAL	1,950	834	1,438	2,372	1,865	525	1,438	2,372

The fair value hedges consist of interest rate swap contracts and cross currency interest rate swap contracts that are used to protect against changes in the fair value of certain fixed rate securities due to movements in market interest rates.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Notional amounts of derivative financial instruments

Analysis of the notional amounts of derivative financial instruments held based on the remaining periods to settlement at the balance sheet date is set out below. The notional amounts of these instruments indicate the volume of outstanding transactions and do not represent amounts at risk.

	Group Notional amounts with remaining life of									
	Total	2005				Total	2004			
		<3 months	3-12 months	1-5 years	>5 years		<3 months	3-12 months	1-5 years	>5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	47,908	9,040	22,903	11,965	4,000	58,269	17,113	13,697	23,459	4,000
Currency derivatives										
Forward foreign exchange contracts	170,673	170,614	59	-	-	152,854	152,854	-	-	-
Others										
Stock index futures contracts	12,736	12,736	-	-	-	12,421	12,421	-	-	-
Bond futures contracts	915	915	-	-	-	989	989	-	-	-
	232,232	193,305	22,962	11,965	4,000	224,533	183,377	13,697	23,459	4,000
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	21,601	1,900	8,423	6,843	4,435	25,000	4,231	3,077	13,599	4,093
Currency derivatives										
Currency swap contracts	83	-	83	-	-	-	-	-	-	-
	21,684	1,900	8,506	6,843	4,435	25,000	4,231	3,077	13,599	4,093
TOTAL	253,916	195,205	31,468	18,808	8,435	249,533	187,608	16,774	37,058	8,093

	Fund Notional amounts with remaining life of									
	Total	2005				Total	2004			
		<3 months	3-12 months	1-5 years	>5 years		<3 months	3-12 months	1-5 years	>5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	7,900	-	500	3,400	4,000	9,400	500	1,000	3,900	4,000
Currency derivatives										
Forward foreign exchange contracts	170,615	170,614	1	-	-	152,854	152,854	-	-	-
Others										
Stock index futures contracts	12,736	12,736	-	-	-	12,421	12,421	-	-	-
Bond futures contracts	915	915	-	-	-	989	989	-	-	-
	192,166	184,265	501	3,400	4,000	175,664	166,764	1,000	3,900	4,000
TOTAL	192,166	184,265	501	3,400	4,000	175,664	166,764	1,000	3,900	4,000

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

9. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS/ OTHER INVESTMENTS IN SECURITIES

(a) Financial assets designated at fair value through profit or loss

At fair value	Group and Fund	
	2005	2004
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	1,637	–
Unlisted	170,896	–
Certificates of deposit		
Unlisted	21,908	–
Other debt securities		
Listed		
In Hong Kong	187	–
Outside Hong Kong	284,243	–
Unlisted	256,431	–
Total debt securities	735,302	–
Equity securities		
Listed		
In Hong Kong	87,872	–
Outside Hong Kong	124,230	–
Unlisted	5,741	–
Total equity securities	217,843	–
TOTAL	953,145	–

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Other investments in securities

At fair value	Group and Fund	
	2005	2004
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	-	3,119
Unlisted	-	271,847
Certificates of deposit		
Unlisted	-	12,637
Other debt securities		
Listed		
In Hong Kong	-	1,518
Outside Hong Kong	-	342,179
Unlisted	-	140,816
Total debt securities	-	772,116
Equity securities		
Listed		
In Hong Kong	-	82,417
Outside Hong Kong	-	123,213
Total equity securities	-	205,630
TOTAL	-	977,746

Following the adoption of HKAS 39 in 2005, "other investments in securities" with a carrying amount of HK\$977,746 million (note 9(b)) and unlisted equity securities with a carrying amount of HK\$985 million previously included in "other assets" (note 14) were re-designated as financial assets at fair value through profit or loss on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

10. AVAILABLE-FOR-SALE SECURITIES / INVESTMENT SECURITIES

(a) Available-for-sale securities

	Group		Fund	
	2005	2004	2005	2004
Debt securities, at fair value				
Listed in Hong Kong	16	–	–	–
Unlisted	1,563	–	–	–
	1,579	–	–	–
Equity securities				
Listed in Hong Kong, at fair value	411	–	–	–
Unlisted, at cost	493	–	493	–
TOTAL	2,483	–	493	–

(b) Investment securities

	Group		Fund	
	2005	2004	2005	2004
Unlisted equity securities, at cost	–	300	–	300

The Group's investment in unlisted equity securities at 31 December 2005 represents a holding of 4,285 shares (2004: 3,000 shares) in the Bank for International Settlements (also see note 32(a)) with a nominal value of 5,000 Special Drawing Rights each. These shares are 25% paid.

On the adoption of HKAS 39, 3,000 shares with a carrying amount of HK\$300 million, which were previously included in "investment securities", were re-designated as "available-for-sale securities" on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted. During the year, the Fund subscribed for a further 1,285 shares, which are also 25% paid.

11. HELD-TO-MATURITY SECURITIES

At amortised cost	Group		Fund	
	2005	2004	2005	2004
Debt securities				
Listed				
In Hong Kong	593	224	–	–
Outside Hong Kong	998	1,424	–	–
Unlisted	3,014	2,482	–	–
TOTAL	4,605	4,130	–	–

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

12. MORTGAGE LOANS

	Group		Fund	
	2005	2004	2005	2004
Outstanding principal balance of mortgage loans, at amortised cost	29,529	35,052	-	-
Allowance for loan impairment	(53)	-	-	-
Provisions for bad and doubtful loans	-	(114)	-	-
TOTAL	29,476	34,938	-	-

13. GOLD

	Group and Fund	
	2005	2004
Gold, at market value 66,798 ounces (2004: 66,798 ounces)	266	228

14. OTHER ASSETS

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Interest and dividends receivable	8,793	8,926	8,475	8,610
Prepayments, receivables and other assets	4,728	633	4,186	35
Unsettled sales and redemption of securities	3,225	2,031	3,225	2,031
Exchange difference on Certificates of Indebtedness, government-issued currency notes and coins in circulation (note 3.3(c))	-	536	-	536
Staff housing loans	263	279	263	279
Tax recoverable	6	-	-	-
Deferred tax assets	-	8	-	-
Unlisted equity securities (note 9)	-	985	-	985
TOTAL	17,015	13,398	16,149	12,476

15. INVESTMENTS IN SUBSIDIARIES

	Fund	
	2005	2004
Unlisted shares, at cost	2,145	2,145

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

The following is a list of the subsidiaries as at 31 December 2005 and 2004:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Banknote printing	HK\$255,000,000	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages, mortgage securitisation and guarantee	HK\$2,000,000,000	100%
Exchange Fund Investment Limited	Hong Kong	Dormant	HK\$5,000,000	100%
Hong Kong Institute for Monetary Research	Hong Kong	Research	HK\$2	100%

All subsidiaries are held directly by the Fund.

The HKMC has unissued authorised share capital of HK\$1 billion (2004: HK\$1 billion), which is callable from the Fund.

16. INVESTMENT IN ASSOCIATE

	Group		Fund	
	2005	2004	2005	2004
Unlisted shares, at cost	-	-	-	-
Share of net assets	26	23	-	-
TOTAL	26	23	-	-

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2004: HK\$5,000). Details of the associate are as follows:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Interbank Clearing Limited	Hong Kong	Interbank clearing	HK\$10,000	50%

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

17. PROPERTY, PLANT AND EQUIPMENT**(a)**

	Group		
	Premises	Plant and equipment	Total
Cost			
At 1 January 2004 (restated)	624	522	1,146
Additions (restated)	–	46	46
Disposals	(1)	(15)	(16)
At 31 December 2004 (restated)	623	553	1,176
At 1 January 2005 (restated)	623	553	1,176
Additions	–	65	65
Disposals	(2)	(6)	(8)
At 31 December 2005	621	612	1,233
Accumulated depreciation			
At 1 January 2004 (restated)	5	236	241
Charge for the year (restated)	14	51	65
Written back on disposal	–	(15)	(15)
At 31 December 2004 (restated)	19	272	291
At 1 January 2005 (restated)	19	272	291
Charge for the year	13	47	60
Written back on disposal	–	(6)	(6)
At 31 December 2005	32	313	345
Net book value			
At 31 December 2005	589	299	888
At 31 December 2004 (restated)	604	281	885

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund		
	Premises	Plant and equipment	Total
Cost			
At 1 January 2004 (restated)	615	163	778
Additions (restated)	–	19	19
Disposals	(1)	(1)	(2)
At 31 December 2004 (restated)	614	181	795
At 1 January 2005 (restated)	614	181	795
Additions	–	21	21
Disposals	(2)	(5)	(7)
At 31 December 2005	612	197	809
Accumulated depreciation			
At 1 January 2004 (restated)	4	127	131
Charge for the year (restated)	14	16	30
Written back on disposal	–	(1)	(1)
At 31 December 2004 (restated)	18	142	160
At 1 January 2005 (restated)	18	142	160
Charge for the year	13	16	29
Written back on disposal	–	(5)	(5)
At 31 December 2005	31	153	184
Net book value			
At 31 December 2005	581	44	625
At 31 December 2004 (restated)	596	39	635

(b) The net book value of premises comprises:

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Held in Hong Kong				
Medium-term leasehold (between 10 and 50 years)	565	580	557	572
Held outside Hong Kong				
Freehold	24	24	24	24
TOTAL	589	604	581	596

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

18. OPERATING LAND LEASE PREPAYMENT

	Group and Fund	
	2005	2004 (restated)
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated depreciation		
At 1 January	86	12
Charge for the year	74	74
At 31 December	160	86
Net book value		
At 31 December	3,071	3,145

19. INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2005	2004 (restated)
Cost		
At 1 January	228	222
Additions	4	6
At 31 December	232	228
Accumulated amortisation		
At 1 January	186	170
Charge for the year	13	16
At 31 December	199	186
Net book value		
At 31 December	33	42

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

20. CERTIFICATES OF INDEBTEDNESS, GOVERNMENT-ISSUED CURRENCY NOTES AND COINS IN CIRCULATION

	Group and Fund			
	Certificates of Indebtedness		Government-issued currency notes and coins in circulation	
	2005	2004	2005	2004
Carrying amount	148,406	146,775	6,671	6,351
Reconciliation with face value:				
Hong Kong dollar face value	HK\$149,295	HK\$146,775 ¹	HK\$6,711	HK\$6,351 ¹
Linked exchange rate for calculating the US dollars required for redemption	US\$1=HK\$7.80		US\$1=HK\$7.80	
US dollars required for redemption	US\$19,140		US\$860	
Market exchange rate for translation into Hong Kong dollars	US\$1=HK\$7.7536		US\$1=HK\$7.7536	
Carrying amount	HK\$148,406		HK\$6,671	

¹ Certificates of Indebtedness and government-issued currency notes and coins in circulation were stated at their Hong Kong dollar face value at 31 December 2004 (note 3.3(c)).

21. BALANCE OF THE BANKING SYSTEM

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the HKMA for the account of the Fund. The aggregate amounts in these clearing accounts, which must not have a negative balance, represents the total level of liquidity in the interbank market.

Under the weak-side Convertibility Undertaking, the HKMA undertakes to convert Hong Kong dollars in these clearing accounts into US dollars at the fixed exchange rate of US\$1=HK\$7.85. Likewise, under the strong-side Convertibility Undertaking, licensed banks can convert US dollars into Hong Kong dollars in these accounts, as the HKMA undertakes to buy US dollars at the fixed rate of US\$1=HK\$7.75. Within the Convertibility Zone bounded by the two Convertibility Undertakings, the HKMA may choose to conduct market operations in a manner consistent with Currency Board principles. Such operations can result in matching changes in the balances of these accounts.

The balance of the banking system is repayable on demand, non-interest bearing and is shown at its Hong Kong dollar amount.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

22. PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

At amortised cost	Group and Fund	
	2005	2004
Placements by banks and other financial institutions in respect of securities lending (note 30)	1,001	–
Other placements by banks and other financial institutions	24,711	39,087
TOTAL	25,712	39,087

23. PLACEMENTS BY OTHER HKSAR GOVERNMENT FUNDS

	Group and Fund	
	2005	2004
Placements with interest payable at rates determined by reference to the investment income of the Fund		
General Revenue Account	101,006	90,488
Land Fund	124,334	117,774
Capital Works Reserve Fund	44,273	40,551
Civil Service Pension Reserve Fund	15,294	14,523
Disaster Relief Fund	32	19
Innovation and Technology Fund	4,332	4,292
Lotteries Fund	4,569	4,087
	293,840	271,734
Placements with interest payable at market-based rates		
General Revenue Account	288	481
Capital Investment Fund	852	5,138
Loan Fund	1,295	1,897
Capital Works Reserve Fund	488	564
Innovation and Technology Fund	92	64
Lotteries Fund	231	213
	3,246	8,357
TOTAL	297,086	280,091

Placements by other HKSAR government funds are not permanently appropriated for the use of the Fund, and the majority are repayable on demand. As at 31 December 2005, the interest payable on these placements amounted to HK\$10,068 million (2004: HK\$14,542 million) and is included in “other liabilities” (note 26).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

24. EXCHANGE FUND BILLS AND NOTES ISSUED

At fair value	Group and Fund	
	2005	2004
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	69,384	68,538
Exchange Fund Notes	57,019	57,322
	126,403	125,860
Exchange Fund Bills and Notes held		
Exchange Fund Bills	(7,333)	-
Exchange Fund Notes	(936)	-
	(8,269)	-
TOTAL	118,134	125,860

EFBN issued are unsecured obligations of the Fund and are one of the components of the Monetary Base in the Currency Board Account. Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year and 10-year maturities. EFBN issued are valued at offer prices derived from Reuters fixings adjusted by observed market spreads.

Following the adoption of HKAS 39 in 2005, all EFBN were designated as at fair value through profit or loss on 1 January 2005. There is no change to the accounting treatment as the EFBN were also carried at fair value with changes in value recorded in the income and expenditure account in prior years.

With effect from 1 January 2005, EFBN held by the Fund as a result of market making activities are considered a redemption of the EFBN issued and are derecognised. At 31 December 2004, EFBN held of HK\$1,315 million were classified as "other investments in securities".

The reconciliation of the redemption amount of EFBN issued at the beginning and the end of year is set out below:

	Group and Fund			
	2005		2004	
Redemption amount	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Exchange Fund Bills and Notes issued by Currency Board Operations segment				
At 1 January	68,579	54,000	68,352	51,800
Issuance	197,261	16,500	190,586	15,400
Redemption	(195,831)	(13,800)	(190,359)	(13,200)
At 31 December	70,009	56,700	68,579	54,000
Long position in Exchange Fund Bills and Notes held by Financial Stability and Other Activities segment at 31 December	(7,359)	(877)	-	-
Total redemption amount	62,650	55,823	68,579	54,000
Carrying amount, at fair value	62,051	56,083	68,538	57,322
Difference	599	(260)	41	(3,322)

The fair value changes of EFBN issued are attributable to changes in benchmark interest rates.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

25. OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2005	2004	2005	2004
Debt securities issued, carried at amortised cost				
Notes	3,900	32,495	-	-
Transferable loan certificates	-	3,000	-	-
	3,900	35,495	-	-
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	21,491	-	-	-
	25,391	35,495	-	-
Debt securities issued, designated at fair value through profit or loss				
Notes	2,600	-	-	-
TOTAL	27,991	35,495	-	-

Following the adoption of HKAS 39 in 2005, debt securities issued with a total carrying amount of HK\$2,995 million, previously carried at amortised cost, were designated as financial liabilities at fair value through profit or loss on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted.

The reconciliation of redemption amount of other debt securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2005	2004	2005	2004
Total debt securities issued				
Redemption amount at 1 January	35,495	36,620	-	-
Issuance	5,096	11,399	-	-
Redemption	(12,348)	(12,524)	-	-
Redemption amount at 31 December	28,243	35,495	-	-
Carrying amount	27,991	35,495	-	-
Difference	252	-	-	-
Debt securities issued, designated at fair value through profit or loss:				
Redemption amount	2,664	-	-	-
Carrying amount, at fair value	2,600	-	-	-
Difference	64	-	-	-

The fair value changes of debt securities issued designated at fair value through profit or loss are attributable to changes in benchmark interest rates.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

26. OTHER LIABILITIES

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Interest payable on placements by other HKSAR government funds				
– at rates determined by reference to the investment income of the Fund	10,060	14,533	10,060	14,533
– at market-based rates	8	9	8	9
	10,068	14,542	10,068	14,542
Other interest payable	828	766	591	538
Unsettled purchases of securities	7,183	6,545	7,183	6,545
Accrued charges and other liabilities	6,495	5,555	304	213
Tax payable	–	54	–	–
Deferred tax liabilities	62	37	–	–
TOTAL	24,636	27,499	18,146	21,838

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

27. EQUITY

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Accumulated surplus				
At 1 January, as previously reported	425,644	386,441	423,397	384,870
Prior year adjustment in respect of HKAS 16 and 17 (note 3.1.2)	(20)	876	(20)	876
At 1 January, as restated, before opening balance adjustment	425,624	387,317	423,377	385,746
Opening balance adjustment in respect of HKAS 39 (note 3.1.2)	(485)	–	(556)	–
At 1 January, as restated, after opening balance adjustment	425,139	387,317	422,821	385,746
Surplus for the year	20,689	38,307	20,325	37,631
At 31 December	445,828	425,624	443,146	423,377
Premises revaluation reserve				
At 1 January, as previously reported	194	9	194	9
Prior year adjustment in respect of HKAS 16 and 17 (note 3.1.2)	(194)	(9)	(194)	(9)
At 1 January and 31 December, as restated	–	–	–	–
Available-for-sale securities revaluation reserve				
At 1 January	–	–	–	–
Net fair value gains, net of tax	87	–	–	–
Net losses transferred to income and expenditure account on disposal	7	–	–	–
At 31 December	94	–	–	–
Minority interests				
Balance included in equity at 1 January, as previously reported	–	–	–	–
Reclassification (note 3.1.2)	167	160	–	–
At 1 January, as restated	167	160	–	–
Surplus for the year	23	21	–	–
Dividends paid to minority interests	(12)	(14)	–	–
At 31 December	178	167	–	–
TOTAL	446,100	425,791	443,146	423,377

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

28. NOTES TO THE CASH FLOW STATEMENT

Analysis of cash and cash equivalents in the cash flow statement

	Group		Fund	
	2005	2004	2005	2004
Cash and money at call	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	75,639	48,158	73,120	42,747
Treasury bills and commercial paper	112,776	97,298	112,776	97,298
Certificates of deposit	14,170	12,637	14,170	12,637
TOTAL	218,522	178,852	215,953	173,420

Reconciliation with the balance sheet

	Note	Group		Fund	
		2005	2004	2005	2004
Amounts shown in the balance sheet					
Cash and money at call	6	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	7	75,648	48,178	73,120	42,747
Financial assets designated at fair value through profit or loss					
– Treasury bills and commercial paper	9(a)	172,533	–	172,533	–
– Certificates of deposit	9(a)	21,908	–	21,908	–
Other investments in securities					
– Treasury bills and commercial paper	9(b)	–	274,966	–	274,966
– Certificates of deposit	9(b)	–	12,637	–	12,637
		286,026	356,540	283,448	351,088
Less: Amounts with original maturity beyond 3 months		(67,504)	(177,688)	(67,495)	(177,668)
Cash and cash equivalents in the cash flow statement		218,522	178,852	215,953	173,420

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

29. SEGMENT REPORTING

The activities of the Fund managed by the HKMA comprise the following business segments:

- Management of funds under the Currency Board Operations;
- Management of funds representing the general reserve assets of the Fund; and
- Maintaining the stability and integrity of financial and banking system of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

	Currency Board Operations		Reserves Management		Group Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2005	2004	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)
INCOME	10,842	5,549	26,341	51,003	37,183	56,552	2,431	1,673	39,614	58,225
Expenditure										
Interest expense	3,062	2,559	12,843	15,295	15,905	17,854	1,085	212	16,990	18,066
Other expenses (note 29(b))	-	-	-	-	818	632	997	1,093	1,815	1,725
	3,062	2,559	12,843	15,295	16,723	18,486	2,082	1,305	18,805	19,791
Surplus before share of profit of associate	7,780	2,990	13,498	35,708	20,460	38,066	349	368	20,809	38,434
Share of profit of associate	-	-	-	-	-	-	3	3	3	3
Surplus before taxation	7,780	2,990	13,498	35,708	20,460	38,066	352	371	20,812	38,437
Income tax	-	-	-	-	-	-	(100)	(109)	(100)	(109)
Surplus for the year	7,780	2,990	13,498	35,708	20,460	38,066	252	262	20,712	38,328
Attributable to:										
Owner of the Fund	7,780	2,990	13,498	35,708	20,460	38,066	229	241	20,689	38,307
Minority interests	-	-	-	-	-	-	23	21	23	21
	7,780	2,990	13,498	35,708	20,460	38,066	252	262	20,712	38,328

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 29(c) & (d))		Total	
	2005	2004	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)	2005	2004	2005	2004 (restated)
Assets												
Backing Assets												
Investment in designated US dollar assets	314,228	326,823	-	-	314,228	326,823	-	-	-	-	314,228	326,823
Interest receivable on designated US dollar assets	1,408	453	-	-	1,408	453	-	-	-	-	1,408	453
Net accounts receivable	1,221	-	-	-	1,221	-	-	-	52	-	1,273	-
Other investments	-	-	727,638	713,065	727,638	713,065	47,679	46,414	(7,959)	-	767,358	759,479
Other assets	-	-	14,617	11,427	14,617	11,427	5,510	6,648	149	380	20,276	18,455
TOTAL ASSETS	316,857	327,276	742,255	724,492	1,059,112	1,051,768	53,189	53,062	(7,758)	380	1,104,543	1,105,210
Liabilities												
Monetary Base												
Certificates of Indebtedness	148,406	146,775	-	-	148,406	146,775	-	-	-	-	148,406	146,775
Government-issued currency notes and coins in circulation	6,671	6,351	-	-	6,671	6,351	-	-	-	-	6,671	6,351
Balance of the banking system	1,561	15,789	-	-	1,561	15,789	-	-	-	-	1,561	15,789
Exchange Fund Bills and Notes issued	126,403	125,860	-	-	126,403	125,860	-	-	(8,269)	-	118,134	125,860
Interest payable on Exchange Fund Notes	431	476	-	-	431	476	-	-	-	-	431	476
Net accounts (receivable)/payable	(426)	(380)	-	-	(426)	(380)	-	-	459	380	33	-
Other debt securities issued	-	-	-	-	-	-	27,991	35,495	-	-	27,991	35,495
Placements by banks and other financial institutions	-	-	25,712	39,087	25,712	39,087	-	-	-	-	25,712	39,087
Placements by other HKSAR government funds	-	-	297,086	280,091	297,086	280,091	-	-	-	-	297,086	280,091
Other liabilities	-	-	18,085	23,648	18,085	23,648	14,281	5,847	52	-	32,418	29,495
Total liabilities	283,046	294,871	340,883	342,826	623,929	637,697	42,272	41,342	(7,758)	380	658,443	679,419
Accumulated surplus												
At 1 January	32,405	29,415	381,666	345,431	414,071	374,846	11,553	12,471	-	-	425,624	387,317
Effect of adopting HKAS 39	(44)	-	(513)	-	(557)	-	72	-	-	-	(485)	-
Surplus for the year attributable to owner of the Fund	7,780	2,990	13,498	35,708	20,460	38,066	229	241	-	-	20,689	38,307
Transfer between Currency Board Operations and general reserves (note 29(e))	(6,330)	-	6,721	527	1,209	1,159	(1,209)	(1,159)	-	-	-	-
At 31 December	33,811	32,405	401,372	381,666	435,183	414,071	10,645	11,553	-	-	446,100	425,624
Revaluation reserve	-	-	-	-	-	-	94	-	-	-	94	-
Minority interests	-	-	-	-	-	-	178	167	-	-	178	167
Total equity	33,811	32,405	401,372	381,666	435,183	414,071	10,917	11,720	-	-	446,100	425,791
TOTAL LIABILITIES AND EQUITY	316,857	327,276	742,255	724,492	1,059,112	1,051,768	53,189	53,062	(7,758)	380	1,104,543	1,105,210

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(a) Currency Board Operations

Starting from 1 October 1998, specific US dollar assets of the Fund have been designated to back the Monetary Base, which comprises Certificates of Indebtedness, government-issued currency notes and coins in circulation, the balance of the banking system and EFBN. While specific assets of the Fund have been earmarked for backing the Monetary Base, all the Fund assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the Linked Exchange Rate system.

(b) Other expenses

"Other expenses" of Currency Board Operations segment and Reserves Management segment are aggregated as there is no meaningful basis to allocate between these two segments.

(c) Re-allocation of assets and liabilities

For the purpose of the Currency Board Operations segment, certain liabilities of the Fund are deducted from the Backing Assets and certain assets are deducted from the Monetary Base in order to allow proper computation of the Backing Ratio. This re-allocation adjustment adds back these items in order to reconcile the segmental information to the Group's balance sheet.

As at 31 December 2005, deduction from the Backing Assets comprises:

- "other liabilities" of HK\$52 million (2004: Nil) – Accounts payable for unsettled transactions of redemption of Certificates of Indebtedness are included in "net accounts receivable" in arriving at the Backing Assets.

As at 31 December 2005, deductions from the Monetary Base comprise:

- "other assets" of HK\$149 million (2004: HK\$380 million) – As Hong Kong dollar interest rate swaps have been used as a means to manage the cost of issuing Exchange Fund Notes, interest receivable of HK\$2 million (2004: HK\$11 million) and revaluation gains of HK\$147 million (2004: HK\$369 million) on these interest rate swaps are included in "net accounts payable" to reduce the Monetary Base; and
- "other investments" of HK\$310 million (2004: Nil) – When Hong Kong dollar overnight advances secured on EFBN have been made to banks under the Discount Window Operations, the advances are included in "net accounts receivable" to reduce the amount of the balance of the banking system in arriving at the Monetary Base.

(d) Following the adoption of HKAS 39, as at 31 December 2005 EFBN held by the Financial Stability and Other Activities segment are treated as redemption of EFBN issued in the Currency Board Operations segment.

(e) In accordance with an arrangement approved by the Financial Secretary in January 2000, assets can be transferred between the backing and general reserve portfolios when the Backing Ratio reaches either the upper trigger point (112.5%) or the lower trigger point (105%). This arrangement allows transfer of excess assets out of the backing portfolio to maximise their earning potential while ensuring that there are sufficient liquid assets in the backing portfolio.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

30. PLEDGED ASSETS

Assets are pledged as margin for stock index and bond futures contracts as well as securities lending agreements. Securities lent do not include EFBN in issue. There are no financial assets pledged against contingent liabilities.

	Group and Fund	
	2005	2004
Secured liabilities		
Placements by banks and other financial institutions in respect of securities lending (note 22)	1,001	–
Stock index and bond futures contracts – notional amount (note 8(b))	13,651	13,410
Assets pledged		
Financial assets designated at fair value through profit or loss, carried at fair value	1,978	1,148

During the year, the Group entered into collateralised reverse repurchase agreements, repurchase agreements and securities lending transactions that may result in credit exposure in the event that the counterparty to the transaction is unable to fulfil its contractual obligations. The Group controls credit risk associated with these activities by monitoring counterparty credit exposure and collateral values on a daily basis and requiring additional collateral to be deposited with or returned to the Group when deemed necessary.

31. COMMITMENTS

(a) Capital commitments

Capital expenditure authorised but not provided for in the financial statements at the balance sheet date was as follows:

	Group		Fund	
	2005	2004	2005	2004
Authorised but not contracted for	62	37	50	17

(b) Credit facility to the International Monetary Fund

On 27 January 1997, the HKMA participated in the New Arrangements to Borrow (NAB), a standby credit facility provided to the International Monetary Fund (IMF) for the purpose of managing instability in the international monetary system. At 31 December 2005, the HKMA had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$3,768 million equivalent (2004: HK\$4,104 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2005, there was no outstanding balance due from the IMF under this NAB facility (2004: Nil).

(c) Repurchase agreements with other central banks

The HKMA has entered into bilateral repurchase agreements with various central banks in Asia and Australasia. The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. No transactions took place under this arrangement with any central bank during the year ended 31 December 2005.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(d) Lease commitments

At 31 December 2005, the total future minimum lease payments under non-cancellable operating leases were payable as follows:

	Group		Fund	
	2005	2004	2005	2004
Premises, leases expiring:				
Not later than one year	3	3	3	3
Later than one year and not later than five years	6	–	6	–
Later than five years	3	–	3	–
TOTAL	12	3	12	3

32. CONTINGENT LIABILITIES

- (a) At 31 December 2005, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$178 million equivalent (2004: 11.25 million Special Drawing Rights or HK\$136 million equivalent), in respect of the uncalled portion of its 4,285 shares (2004: 3,000 shares) in the Bank for International Settlements (note 10).
- (b) Under the Mortgage Insurance Programme, the HKMC offers mortgage insurance that covers approved sellers for credit losses of up to 25% of the value of properties financed under mortgage loans where the loan amount exceeds 70% of the property value at origination. The HKMC reinsures the exposure with approved reinsurers. At 31 December 2005, the total risk-in-force assumed by the HKMC was HK\$2.64 billion (2004: HK\$1.77 billion).
- (c) Under the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme and the Bauhinia Mortgage-Backed Securitisation Programme, the HKMC sells mortgages to two SPEs which issue mortgage-backed securities to investors. The HKMC provides a guarantee on the timely payment of principal and interest in respect of the mortgage-backed securities. At 31 December 2005, the aggregate principal balance guaranteed by the HKMC under the two programmes was HK\$5.20 billion (2004: HK\$5.87 billion).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

33. MATERIAL RELATED PARTY TRANSACTIONS

Transactions with related parties are conducted at rates determined by the Monetary Authority taking into account the nature of each transaction on a case-by-case basis.

In addition to the transactions and balances disclosed elsewhere in these financial statements, the Group entered into the following material related party transactions.

During the year, the HKMC purchased HK\$174 million (2004: HK\$10 billion) of mortgage loans from the HKSAR Government.

The Exchange Fund Advisory Committee (EFAC) through its Sub-Committees advises the Financial Secretary in his control of the Exchange Fund. Members of EFAC and its Sub-Committees are appointed in a personal capacity by the Financial Secretary for the expertise and experience that they can bring to the Committees. It is not appropriate to disclose details of transactions with companies related to Committee members as all such transactions have been conducted as a normal part of the operation of the Fund and on terms consistent with its ongoing operations.

34. SPECIAL PURPOSE ENTITIES

Effects of the non-consolidation of special purpose entities established by the HKMC

Prior to 1 January 2005, the HKMC established two securitisation programmes (note 32(c)). These securitisations involve transferring mortgages to two SPEs which fund the purchase of these mortgages by issuing mortgage-backed securities (MBS). The HKMC guarantees the payment of principal and interest on the MBS issued by both SPEs. These SPEs are not consolidated in the financial statements as they do not meet the legal definition of a subsidiary set out in the Hong Kong Companies Ordinance.

In prior years, all mortgage loans sold to the SPEs were no longer recognised as an asset in the balance sheet of the Group. Following the adoption of HKAS 39, mortgage loans sold to the SPEs are derecognised only when the rights to receive cash flows from the financial assets have expired or have been transferred and the HKMC has transferred substantially all risks and rewards of ownership. The derecognition requirements do not apply to mortgage loans sold before 1 January 2005 and so the loans previously sold to the SPEs are not included in the Group's balance sheet.

During the year, the HKMC sold HK\$1 billion of mortgage loans to one of the SPEs, Bauhinia MBS Limited, which issued the same amount of MBS guaranteed by the HKMC under the Bauhinia MBS Programme. As this transfer does not meet the new derecognition requirements, the HKMC continues to recognise an asset to the extent of the guarantee given of HK\$1 billion within "mortgage loans". A liability due to Bauhinia MBS Limited of HK\$1 billion in respect of the funding received is also recognised within "other liabilities".

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

If the two SPEs had been consolidated, the Group's assets and liabilities would have increased/decreased as shown in the table below. Surplus for the year of the Group would have increased by HK\$0.04 million (2004: HK\$0.04 million).

	Increase / (decrease) in assets and liabilities	
	2005	2004
At 31 December		
Mortgage portfolio, net	4,076	5,581
Total assets	4,139	5,410
Debt securities	5,164	5,869
Other liabilities	(976)	–
Total liabilities	4,139	5,410

35. RISK MANAGEMENT**35.1 Governance**

The Financial Secretary is advised by EFAC in his control of the Exchange Fund. EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. Members of EFAC are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the HKSAR for the expertise and experience that they can bring to the Committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC.

Among these Sub-Committees, the Investment Sub-Committee monitors the HKMA's investment management activities and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. Operating within the policies and guidelines endorsed by EFAC, the Reserves Management Department conducts the day-to-day investment management and risk management of the Fund.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

35.2 Investment management and control

Investment activities of the Fund are conducted in accordance with the investment benchmark derived from the Fund's investment objectives. The investment benchmark directs the long-term strategic asset allocation of the Fund and is reviewed on a regular basis to ensure that it consistently meets the investment objectives. Changes to the investment benchmark, if required, must be endorsed by EFAC.

The Fund's asset allocation and currency mix set out in the existing investment benchmark are as follows:

Asset type

Bonds	77%
Equities and related investments	23%
	100%

Currency

US\$ bloc ¹	88%
Other currencies	12%
	100%

¹ HK dollar, US dollar and other foreign currencies including Australian dollar, Canadian dollar and New Zealand dollar.

In addition to the investment benchmark, EFAC determines the tactical deviation limits governing the extent to which the Fund's asset and currency allocations may deviate from the investment benchmark. The tactical deviation limits are used to guide the medium term investments for the Fund. The tactical deviation limits are derived from a risk-based approach, taking into account the risk tolerance level set by EFAC and risk contributions of the asset classes and markets that the Fund is allowed to invest in. These risk contributions reflect the neutral allocations of asset markets within the investment benchmark, and the volatility of and correlation across asset markets. Authority to take medium term investment decisions is delegated to senior management of the HKMA down to the Executive Director level.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

35.3 Risks faced by the Fund

35.3.1 Market risk

Market risk is the risk that changes in market variables such as interest rates, equity prices and exchange rates may affect the fair value or cash flows of a financial instrument.

(a) Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in market interest rates. This can be further classified into fair value interest rate risk and cash flow interest rate risk.

Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The Fund is exposed to fair value interest rate risk since a substantial portion of its investments is in fixed rate debt securities. These securities are subject to interest rate risk as their values will fall when market interest rates increase.

Cash flow interest rate risk is the risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Because the Fund has no significant floating rate investments and liabilities, the Fund's future cash flows are not materially affected by potential changes in market interest rates.

As explained in note 23, a significant portion of the Fund's liabilities represents funds placed by other HKSAR government funds that bear interest at rates determined by reference to returns generated on the Fund's assets. As a result, no significant interest rate risk arises in respect of these liabilities, which amounted to HK\$293,840 million (2004: HK\$271,734 million) at 31 December 2005.

The tables below set out the Group's and Fund's exposure to interest rate risk, based on the major interest bearing assets and liabilities stated at carrying amounts and categorised by the earlier of contractual re-pricing dates or maturity dates and stating the weighted average effective interest rate for each group of assets and liabilities.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Weighted average effective interest rate	Group – 2005 Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	4.10%	15,416	-	-	-	-	-	15,416	521
Placements with banks and other financial institutions	4.08%	74,452	1,186	10	-	-	-	75,648	-
Financial assets designated at fair value through profit or loss	4.09%	132,616	78,134	54,389	280,760	151,737	37,666	735,302	217,843
Available-for-sale securities	4.35%	851	728	-	-	-	-	1,579	904
Held-to-maturity securities	4.47%	-	685	516	2,242	1,162	-	4,605	-
Mortgage loans	5.48%	29,106	217	81	72	-	-	29,476	-
Interest-bearing assets		252,441	80,950	54,996	283,074	152,899	37,666	862,026	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(61,985)	(22,348)	(15,328)	(79,124)	(42,763)	(10,615)	(232,163)	(61,677)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		190,456	58,602	39,668	203,950	110,136	27,051	629,863	
Liabilities									
Trading liabilities	3.50%	1,416	5,966	30	-	-	-	7,412	-
Placements by banks and other financial institutions	3.89%	19,712	6,000	-	-	-	-	25,712	-
Placements by other HKSAR government funds with interest payable at market-based rates	3.55%	2,786	460	-	-	-	-	3,246	-
Exchange Fund Bills and Notes issued	3.77%	12,651	32,004	30,022	33,279	10,178	-	118,134	-
Other debt securities issued	4.22%	2,780	3,806	9,297	7,747	3,446	915	27,991	-
Interest-bearing liabilities		39,345	48,236	39,349	41,026	13,624	915	182,495	
Interest sensitivity gap		151,111	10,366	319	162,924	96,512	26,136	447,368	

¹ Placements by other HKSAR government funds at rates determined by reference to the investment income of the Fund have the same interest rate risk profile as the Fund. Amounts placed by such funds have therefore been allocated across the repricing periods in the same proportion as the total assets of the Fund.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

	Weighted average effective interest rate	Group – 2004 Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	2.26%	20,097	-	-	-	-	-	20,097	662
Placements with banks and other financial institutions	2.23%	44,236	3,923	19	-	-	-	48,178	-
Other investments in securities	2.90%	104,646	144,789	83,116	260,001	140,225	39,339	772,116	205,630
Held-to-maturity securities	3.72%	966	473	737	1,061	893	-	4,130	-
Mortgage loans	1.87%	33,828	727	358	25	-	-	34,938	-
Interest-bearing assets		203,773	149,912	84,230	261,087	141,118	39,339	879,459	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(43,403)	(38,090)	(21,691)	(67,854)	(36,595)	(10,266)	(217,899)	(53,835)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		160,370	111,822	62,539	193,233	104,523	29,073	661,560	
Liabilities									
Trading liabilities	0.06%	100	-	-	-	-	-	100	-
Placements by banks and other financial institutions	0.56%	32,075	7,012	-	-	-	-	39,087	-
Placements by other HKSAR government funds with interest payable at market-based rates	0.44%	4,512	3,845	-	-	-	-	8,357	-
Exchange Fund Bills and Notes issued	0.73%	15,272	36,124	31,217	32,628	10,619	-	125,860	-
Other debt securities issued	3.22%	5,570	6,957	4,614	14,261	3,598	495	35,495	-
Interest-bearing liabilities		57,529	53,938	35,831	46,889	14,217	495	208,899	
Interest sensitivity gap		102,841	57,884	26,708	146,344	90,306	28,578	452,661	

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Weighted average effective interest rate	Fund - 2005 Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	4.10%	15,371	-	-	-	-	-	15,371	516
Placements with banks and other financial institutions	4.08%	71,957	1,163	-	-	-	-	73,120	-
Financial assets designated at fair value through profit or loss	4.09%	132,616	78,134	54,389	280,760	151,737	37,666	735,302	217,843
Available-for-sale securities	-	-	-	-	-	-	-	-	493
Interest-bearing assets		219,944	79,297	54,389	280,760	151,737	37,666	823,793	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(61,985)	(22,348)	(15,328)	(79,124)	(42,763)	(10,615)	(232,163)	(61,677)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		157,959	56,949	39,061	201,636	108,974	27,051	591,630	
Liabilities									
Trading liabilities	3.50%	1,416	5,966	30	-	-	-	7,412	-
Placements by banks and other financial institutions	3.89%	19,712	6,000	-	-	-	-	25,712	-
Placements by other HKSAR government funds with interest payable at market- based rates	3.55%	2,786	460	-	-	-	-	3,246	-
Exchange Fund Bills and Notes issued	3.77%	12,651	32,004	30,022	33,279	10,178	-	118,134	-
Interest-bearing liabilities		36,565	44,430	30,052	33,279	10,178	-	154,504	
Interest sensitivity gap		121,394	12,519	9,009	168,357	98,796	27,051	437,126	

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

	Weighted average effective interest rate	Fund - 2004 Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	2.26%	20,085	-	-	-	-	-	20,085	653
Placements with banks and other financial institutions	2.23%	41,581	1,166	-	-	-	-	42,747	-
Other investments in securities	2.90%	104,646	144,789	83,116	260,001	140,225	39,339	772,116	205,630
Interest-bearing assets		<u>166,312</u>	<u>145,955</u>	<u>83,116</u>	<u>260,001</u>	<u>140,225</u>	<u>39,339</u>	<u>834,948</u>	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(43,403)	(38,090)	(21,691)	(67,854)	(36,595)	(10,266)	(217,899)	(53,835)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		<u>122,909</u>	<u>107,865</u>	<u>61,425</u>	<u>192,147</u>	<u>103,630</u>	<u>29,073</u>	<u>617,049</u>	
Liabilities									
Trading liabilities	0.06%	100	-	-	-	-	-	100	-
Placements by banks and other financial institutions	0.56%	32,075	7,012	-	-	-	-	39,087	-
Placements by other HKSAR government funds with interest payable at market- based rates	0.44%	4,512	3,845	-	-	-	-	8,357	-
Exchange Fund Bills and Notes issued	0.73%	15,272	36,124	31,217	32,628	10,619	-	125,860	-
Interest-bearing liabilities		<u>51,959</u>	<u>46,981</u>	<u>31,217</u>	<u>32,628</u>	<u>10,619</u>	<u>-</u>	<u>173,404</u>	
Interest sensitivity gap		<u>70,950</u>	<u>60,884</u>	<u>30,208</u>	<u>159,519</u>	<u>93,011</u>	<u>29,073</u>	<u>443,645</u>	

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(b) Equity price risk

Equity price risk is the risk of loss arising from changes in equity prices. The Fund's equity investments are subject to equity price risk since the value of these investments will decline if equity prices fall. At 31 December 2005, the majority of equity investments are reported as "financial assets designated at fair value through profit or loss" (2004: Other investments in securities) as shown in note 9.

(c) Currency risk

Currency risk is the risk of loss arising from changes in foreign exchange rates. A large portion of foreign currency assets is held in US dollars with the remaining in other major international currencies. When the exchange rates of the relevant foreign currencies against the Hong Kong dollar fluctuate, the value of these foreign currency assets expressed in Hong Kong dollar will vary accordingly.

Due to the linked exchange rate of the US dollar relative to the Hong Kong dollar, the Fund's currency risk principally arises from its assets and liabilities denominated in "non-US dollar bloc" currencies.

The table below represents the aggregate HK\$ equivalents of foreign currency holdings of the Fund:

	Group			
	2005		2004 (restated)	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	128.3	494.3	128.0	517.3
Other US dollar bloc currencies ¹	848.2	162.7	844.9	159.6
	976.5	657.0	972.9	676.9
Non-US dollar bloc	128.0	1.4	132.3	2.5
TOTAL	1,104.5	658.4	1,105.2	679.4

	Fund			
	2005		2004 (restated)	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	95.6	459.8	92.3	476.2
Other US dollar bloc currencies ¹	843.2	162.5	837.0	159.6
	938.8	622.3	929.3	635.8
Non-US dollar bloc	128.0	1.4	132.3	2.5
TOTAL	1,066.8	623.7	1,061.6	638.3

¹ US dollar and other foreign currencies including Australian dollar, Canadian dollar and New Zealand dollar.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

(d) Monitoring market risks

The investment benchmark and tactical deviation limits of the Fund govern the asset allocation strategies. This, together with the volatility of asset markets, will affect the Fund's market risk exposure. As explained in note 8, the Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies for the Fund. The market risk of the Fund is measured and monitored using the Value-at-Risk (VaR) methodology.

VaR is calculated using the parametric approach based on a 95% confidence level and one-month time horizon. The result represents the maximum expected loss of the Fund over a one-month period under normal market conditions, with a 5% chance that the actual loss may exceed the calculated VaR. The Fund's absolute VaR and the relative VaR (i.e. the VaR of the Fund relative to its investment benchmark), expressed in both dollar amounts and percentage terms, are measured and reported on a regular basis. The relative VaR of the Fund in percentage terms is also used to measure the actual tracking error of the Fund against its investment benchmark. This is regularly monitored against the tracking error limit endorsed by EFAC to ensure that the market risk exposure of the Fund is within its limits.

VaR is a widely accepted measure of market risk within the financial services industry. It provides users with a single amount to measure market risk and takes into account multiple risks. VaR should however be assessed in the context of some of its inherent limitations. The calculation of VaR involves a number of assumptions that may or may not be valid in a real life scenario, in particular in extreme market conditions. The calculation of VaR assumes that future events can be predicted by historical data, and that changes in risk factors follow a normal distribution. In addition, the confidence level on which calculation of VaR is based needs to be taken into account as it indicates the possibility that a larger loss could be realised.

To compensate for some of the limitations of VaR, the HKMA also conducts stress tests to estimate the potential losses under extremely adverse market conditions. This serves to identify the major attributes of market risk under extreme market conditions, and helps to prevent the Fund from being exposed to excessive market risk. The results of the stress tests are also reported to EFAC on a regular basis.

35.3.2 Liquidity risk

Liquidity risk refers to the risk that the Fund may not have sufficient funds available to meet its liabilities as they fall due. In addition, the Fund may not be able to liquidate its financial assets at a price close to fair value within a short period of time.

To ensure sufficient liquidity to meet liabilities and the ability to raise funds to meet exceptional needs, the Fund invests primarily in liquid financial markets and instruments. There are also internal investment restrictions preventing undue concentrations in individual debt securities issues, debt securities issuers, and groups of debt securities issuers. There are also limitations on the maximum proportion of the Fund's assets that can be placed in fixed term deposits, and requirements regarding the Fund's ability to convert its foreign currency assets into cash. Compliance with these limits is monitored on a regular basis.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

The tables below summarise the Group's and Fund's major financial assets and financial liabilities according to maturity groupings based on the remaining period between the balance sheet date and the contractual maturity date.

	Group – 2005							Total
	Remaining maturity						Undated or on demand	
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	-	-	-	-	-	-	15,937	15,937
Placements with banks and other financial institutions	74,452	1,186	10	-	-	-	-	75,648
Financial assets designated at fair value through profit or loss	132,616	78,134	54,389	280,760	151,737	37,666	217,843	953,145
Available-for-sale securities	851	309	-	419	-	-	904	2,483
Held-to-maturity securities	-	669	516	2,243	1,177	-	-	4,605
Mortgage loans	357	336	2,494	12,206	10,272	3,727	84	29,476
	208,276	80,634	57,409	295,628	163,186	41,393	234,768	1,081,294
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	148,406	148,406
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,671	6,671
Balance of the banking system	-	-	-	-	-	-	1,561	1,561
Trading liabilities	1,416	5,966	30	-	-	-	-	7,412
Placements by banks and other financial institutions	19,712	6,000	-	-	-	-	-	25,712
Placements by other HKSAR government funds	1,022	460	-	-	-	-	295,604	297,086
Exchange Fund Bills and Notes issued	12,651	32,004	30,022	33,279	10,178	-	-	118,134
Other debt securities issued	1,280	1,906	8,928	11,516	3,446	915	-	27,991
	36,081	46,336	38,980	44,795	13,624	915	452,242	632,973
Liquidity gap	172,195	34,298	18,429	250,833	149,562	40,478	(217,474)	448,321

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

	Group – 2004							Total
	Remaining maturity						Undated or on demand	
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	-	-	-	-	-	-	20,759	20,759
Placements with banks and other financial institutions	44,236	3,923	19	-	-	-	-	48,178
Other investments in securities	104,646	144,789	83,116	260,001	140,225	39,339	205,630	977,746
Investment securities	-	-	-	-	-	-	300	300
Held-to-maturity securities	962	454	737	1,065	912	-	-	4,130
Mortgage loans	355	500	2,594	12,379	14,593	4,513	4	34,938
	150,199	149,666	86,466	273,445	155,730	43,852	226,693	1,086,051
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	146,775	146,775
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,351	6,351
Balance of the banking system	-	-	-	-	-	-	15,789	15,789
Trading liabilities	100	-	-	-	-	-	-	100
Placements by banks and other financial institutions	32,075	7,012	-	-	-	-	-	39,087
Placements by other HKSAR government funds	1,671	3,845	-	-	-	-	274,575	280,091
Exchange Fund Bills and Notes issued	15,272	36,124	31,217	32,628	10,619	-	-	125,860
Other debt securities issued	270	4,757	5,041	21,334	3,598	495	-	35,495
	49,388	51,738	36,258	53,962	14,217	495	443,490	649,548
Liquidity gap	100,811	97,928	50,208	219,483	141,513	43,357	(216,797)	436,503

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

	Fund - 2005							Total
	Remaining maturity						Undated or on demand	
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	-	-	-	-	-	-	15,887	15,887
Placements with banks and other financial institutions	71,957	1,163	-	-	-	-	-	73,120
Financial assets designated at fair value through profit or loss	132,616	78,134	54,389	280,760	151,737	37,666	217,843	953,145
Available-for-sale securities	-	-	-	-	-	-	493	493
	204,573	79,297	54,389	280,760	151,737	37,666	234,223	1,042,645
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	148,406	148,406
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,671	6,671
Balance of the banking system	-	-	-	-	-	-	1,561	1,561
Trading liabilities	1,416	5,966	30	-	-	-	-	7,412
Placements by banks and other financial institutions	19,712	6,000	-	-	-	-	-	25,712
Placements by other HKSAR government funds	1,022	460	-	-	-	-	295,604	297,086
Exchange Fund Bills and Notes issued	12,651	32,004	30,022	33,279	10,178	-	-	118,134
	34,801	44,430	30,052	33,279	10,178	-	452,242	604,982
Liquidity gap	169,772	34,867	24,337	247,481	141,559	37,666	(218,019)	437,663

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

	Fund - 2004						Undated or on demand	Total
	Remaining maturity							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	-	-	-	-	-	-	20,738	20,738
Placements with banks and other financial institutions	41,581	1,166	-	-	-	-	-	42,747
Other investments in securities	104,646	144,789	83,116	260,001	140,225	39,339	205,630	977,746
Investment securities	-	-	-	-	-	-	300	300
	146,227	145,955	83,116	260,001	140,225	39,339	226,668	1,041,531
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	146,775	146,775
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,351	6,351
Balance of the banking system	-	-	-	-	-	-	15,789	15,789
Trading liabilities	100	-	-	-	-	-	-	100
Placements by banks and other financial institutions	32,075	7,012	-	-	-	-	-	39,087
Placements by other HKSAR government funds	1,671	3,845	-	-	-	-	274,575	280,091
Exchange Fund Bills and Notes issued	15,272	36,124	31,217	32,628	10,619	-	-	125,860
	49,118	46,981	31,217	32,628	10,619	-	443,490	614,053
Liquidity gap	97,109	98,974	51,899	227,373	129,606	39,339	(216,822)	427,478

35.3.3 Credit risk

The Fund is exposed to credit risk as a borrower or a counterparty may not be able or willing to perform its contractual obligations in full when due. Credit risk can be broken down into (i) counterparty risk from lending and placement activities; (ii) counterparty risk from derivatives and trading transactions; (iii) issuer risk arising from debt securities holdings; and (iv) country risk. Credit exposures of the Fund are controlled using various credit limits and controls.

Counterparty credit exposures arise mainly from the Group's lending activities, deposit placements with financial institutions, derivatives transactions and repurchase and reverse repurchase agreements. Since the Fund will conduct transactions with a counterparty for a range of financial instruments, credit limits are established to control the overall exposure to each authorised counterparty based on its credit ratings, financial strength and the size of its total assets and capital. Counterparty credit exposures are measured according to the risk nature of financial products involved in the transaction.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(a) Maximum exposure to counterparty risk

The maximum exposure to counterparty risk in respect of money at call, placements with financial institutions, derivatives transactions and repurchase and reverse repurchase agreements are represented by their carrying amounts on the balance sheet.

For risk management purposes the Fund will also take into account the potential future credit exposure for derivative financial instruments. Therefore, in addition to the positive mark-to-market replacement value of the derivatives contract, an estimate for the potential future credit exposure of the contract is taken into account when calculating the counterparty credit exposure for risk management purposes.

For the HKMC, the credit risk is primarily attributable to its mortgage portfolio, which is the risk that a mortgage borrower will be unable to pay amounts in full when due. Allowance for impairment is provided for losses that have been incurred at the balance sheet date.

Significant changes in the economy and local property market could result in losses that are different from those provided for at the balance sheet date. The HKMC therefore has a prudent policy for managing its exposure to credit risk.

To maintain the asset quality of the mortgage loan and mortgage insurance portfolios, the HKMC adheres to a four-pronged approach to (i) selecting Approved Sellers carefully, (ii) adopting prudent mortgage purchasing criteria and insurance eligibility criteria, (iii) conducting effective due diligence reviews and (iv) ensuring adequate protection for higher-risk mortgages or transactions. The HKMC has no significant concentration of credit risk. Risk exposure is spread over a large number of customers, counterparties and a diversified distribution of underlying collateral in Hong Kong.

(b) Maximum exposure to issuer risk

The following table shows issuer credit exposure by credit rating as at 31 December 2005. The issuer credit exposure represents the carrying amount of the debt securities holdings as indicated in notes 9, 10 and 11.

	Group		Fund	
	2005	2004	2005	2004
Credit rating¹ of the issuers				
AAA	667,086	688,308	666,355	687,210
AA	41,316	55,423	36,334	52,791
A	11,830	10,726	11,369	10,352
BBB+ and below (including un-rated risk)	21,254	21,789	21,244	21,763
	741,486	776,246	735,302	772,116

¹ the lower of Moody's and Standard and Poor's ratings

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

Issuer risk arises from investments in debt securities. Credit limits to approved issuers are set on an individual and group level to control the risk of loss caused by the default of debt securities issuers and to prevent undue risk concentration.

Moreover, to qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Fund. The Fund predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. As at 31 December 2005, approximately 91% of the debt securities held by the Fund were rated "triple-A" by Moody's or Standard and Poor's.

In addition to the counterparty and issuer risk, the Fund is exposed to country risk, which is broadly defined to include both the transfer risk and the sovereign risk. Under the existing framework, country limits are established to control the Fund's overall credit risk exposures to the countries endorsed by EFAC. These country limits are set to reflect the status of a country's sovereign credit quality and the risks of default of the debt issued by its government.

Credit exposure is monitored against the established limits on a daily basis. To ensure prompt identification, proper approval and consistent monitoring of credit risk, the Fund has implemented a unified automated credit monitoring system which provides fully-integrated straight-through-processing linking the front, middle and back office functions. The pre-deal checking takes place in the front office prior to the commitment of any transaction to ensure that the intended transaction will not exceed the credit limits. The end-of-day compliance checking further verifies the compliance of the Fund with the established credit policies and procedures.

Credit exposures of the Fund and compliance with the established limits are reported regularly to the Credit Review Committee of the HKMA based on its delegated authority from EFAC.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

(c) Concentration of credit risk

The following table shows the major concentrations of counterparty credit risk from lending and placement activities at 31 December:

	Group		Fund	
	2005	2004	2005	2004
Financial institutions ¹	91,585	68,937	89,007	63,485
Others ²	29,739	35,217	263	279
	121,324	104,154	89,270	63,764

¹ including money at call and placements with banks and other financial institutions

² including mortgage loans and staff housing loans

Counterparty credit risk is diversified as explained in note 35.3.3(a).

Concentration of counterparty credit risk arising from derivatives activities is limited as all interest rate and currency derivatives are traded with authorised counterparties while futures contracts are transacted through authorised stock exchanges.

The following table shows the issuer credit exposure by industry groups as at 31 December 2005. The issuer credit exposure is the carrying amount of the debt securities as indicated in notes 9, 10 and 11.

	Group		Fund	
	2005	2004	2005	2004
Governments and government agencies ¹	646,677	656,538	646,322	656,275
Supra-nationals	34,654	32,473	34,614	32,456
States, provinces and public-sector entities ²	4,502	36,358	3,615	35,462
Financial institutions	29,188	24,457	25,804	22,500
Others	26,465	26,420	24,947	25,423
	741,486	776,246	735,302	772,116

¹ including debt securities guaranteed by governments

² including debt securities guaranteed by states

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

35.3.4 Mortgage insurance risk

To provide mortgage insurance cover to authorized institutions in respect of mortgage loans originated by such authorized institutions and secured by residential properties, the HKMC faces insurance risk of the uncertainty of the insured event occurring and the uncertainty of the amount of the resulting claim.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the HKMC faces under its insurance contracts is that the actual claims exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims are greater than estimated. The actual number and amount of claims and benefits will vary year to year from the estimate established using statistical techniques.

Experience shows that the larger the portfolio of similar insurance contracts, the smaller the relative variability about the expected outcome will be. In addition, a more diversified portfolio is less likely to be affected across the board by a change in any subset of the portfolio. The HKMC has developed a business strategy to diversify the type of mortgage insurance risks accepted and within each of the key categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome.

The frequency and severity of claims can be affected by several factors which cause collateral values fall below the outstanding balance of the mortgage loans. The most significant are a downturn in the economy and a decline in local property values. Economic downturn, which may cause a rise in defaults, affects the frequency of claims.

The HKMC manages these risks by adopting a set of prudent insurance eligibility criteria. To ensure sufficient provision is set aside for meeting future claim payments, the HKMC calculates technical reserves on prudent liability valuation assumptions and the methods prescribed in the regulatory guidelines. The HKMC also takes out quota-share reinsurance from its approved mortgage reinsurers in an effort to limit its risk exposure. The reinsurers are selected according to prudent criteria and their credit ratings are reviewed regularly.

35.3.5 Operational risk

An internal high-level Risk Committee was established in early 2005. The Committee is chaired by the Chief Executive and the three Deputy Chief Executives serve as members. The Risk Committee provides direction and assistance for senior management in managing risk in the HKMA's operations.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

The HKMA has put in place a formal risk assessment process. This is conducted on an annual basis and requires each division to assess and rank the potential impact and likelihood of occurrence of financial and operational risks that may affect the HKMA and the Fund. It also requires the relevant divisions to review the procedures and measures in place to address the identified risks. The assessment and ranking is then reviewed by Internal Audit for consistency and reasonableness before being submitted to the Risk Committee, which has the responsibility for ensuring that the identified risks are properly addressed. This risk assessment is then used as the basis for the annual Internal Audit plan. Internal Audit will audit the risk areas in various frequencies depending on the levels of risks assigned to the areas.

Internal Audit will report its findings to EFAC Audit Sub-Committee and the Chief Executive of the HKMA. It will also follow up on outstanding issues to ensure that they are resolved in a proper manner.

36. FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date.

The total amount of change in fair value for the Group estimated using a valuation technique that was recognised in the income and expenditure account during the year is HK\$17 million (2004: HK\$41 million).

All financial instruments of the Group are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2005 and 2004 except as follows:

	Group			
	Carrying value		Fair value	
	2005	2004	2005	2004
Financial assets				
Held-to-maturity securities (note 11)	4,605	4,130	4,552	4,194
Financial liabilities				
Other debt securities issued, not designated at fair value through profit or loss (note 25)	25,391	35,495	25,398	36,226

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.

37. COMPARATIVE FIGURES

Certain comparative figures have been adjusted or reclassified as a result of the changes in accounting policies. Further details are disclosed in note 3.

38. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING PERIOD ENDED 31 DECEMBER 2005

Up to the date of issue of the financial statements, the HKICPA has issued the following amendments, new standards and interpretations which are not yet effective for the accounting period ended 31 December 2005:

	Effective for accounting periods beginning on or after
Not adopted in the financial statements	
HKFRS 6, Exploration for and evaluation of mineral resources	1 January 2006
HK(IFRIC)-Int 4, Determining whether an arrangement contains a lease	1 January 2006
HK(IFRIC)-Int 5, Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds	1 January 2006
HK(IFRIC)-Int 6, Liabilities arising from participating in a specific market-Waste electrical and electronic equipment	1 December 2005
Amendments to HKAS 19, Employee benefits-Actuarial Gains and Losses, Group Plans and Disclosures	1 January 2006
Amendments to HKAS 39, Financial instruments:	
Recognition and measurement:	
– Cash flow hedge accounting of forecast intragroup transactions	1 January 2006
Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:	
– HKAS 1, Presentation of financial statements	1 January 2006
– HKAS 27, Consolidated and separate financial statements	1 January 2006
– HKFRS 3, Business combinations	1 January 2006
HKFRS 7, Financial instruments: disclosures	1 January 2007
Amendment to HKAS 1, Presentation of financial statements: Capital disclosures	1 January 2007
Already adopted in the financial statements	
Amendments to HKAS 39, Financial instruments:	
Recognition and measurement:	
– The fair value option	1 January 2006
– Financial guarantee contracts	1 January 2006

The Group is in the process of making an assessment of the impact expected of these amendments, new standards and new interpretations in the period of initial application. So far it has concluded that:

- HKFRS 7 requires more detailed qualitative and quantitative disclosures, primarily in respect of fair values and risk management. The adoption of this standard is therefore only expected to affect the level of detail of the disclosures, and is not expected to have any financial impact nor result in any changes to the Group's accounting policies;

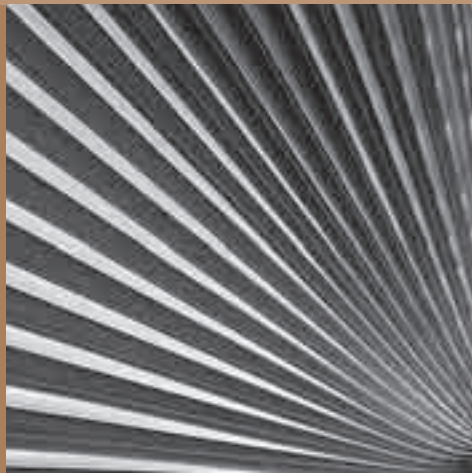
EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

(Amounts expressed in millions of Hong Kong dollars, unless otherwise stated.)

- The adoption of HKFRS 6, HK(IFRIC)-Int 5 and HK(IFRIC)-Int 6 and the amendments to HKAS 1 and HKFRS 3 made as a result of the Hong Kong Companies (Amendment) Ordinance 2005 are not applicable to any of the Group's operations;
- The adoption of the amendments to HKAS 27 made as a result of the Hong Kong Companies (Amendment) Ordinance 2005 requires consolidation in the Group's financial statements of a subsidiary, including special purpose entities as described in note 34, that previously did not meet the legal definition of subsidiary. The Group's surplus for the year and its assets and liabilities are expected to be increased as a result of the consolidation of the subsidiaries; and
- The adoption of the other standards and interpretations is unlikely to have a significant impact on the Group's results of operations and financial position.

39. APPROVAL OF ACCOUNTS

The accounts were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 30 March 2006.



PROFESSIONAL AND CORPORATE SERVICES

The Corporate Services Department, Office of the General Counsel, and Internal Audit Division provide professional and administrative support to the HKMA in carrying out its policy objectives.

THE HKMA IN THE COMMUNITY

The HKMA continued its policy of engaging the community in 2005. The HKMA Information Centre has received more than 110,000 visitors since its opening in late 2003. Visits to the HKMA website exceeded 21 million in 2005, a 40% increase from 2004.

The HKMA has a well-established policy of transparency and accessibility, which is realised through

- extensive contacts with the media
- regular and special publications
- a comprehensive bilingual website
- the HKMA Information Centre
- education programmes for students and community groups
- frequent meetings with legislators
- a public enquiries service staffed nine hours a day.

These services are co-ordinated by the Corporate Development Division within the Corporate Services Department. The Division is responsible for providing media, publications and public communications services to the HKMA. It also provides translation and drafting services, and support to the Exchange Fund Advisory Committee and its Sub-Committees.

Media relations

One of the most important channels of communication between the HKMA and the community is the extensive local and international media. The HKMA maintains close contacts with reporters and editors, handling more than 40 press enquiries each day.

The HKMA tries to be as open and responsive as possible with the media, in accordance with its policy of transparency. Five press conferences were held and 263 press releases were issued in 2005. Special briefings were arranged for the financial press on the refinements to the Linked Exchange Rate system introduced in May 2005 to help reporters understand the reasons for and effects of the refinements.

Publications

The HKMA produces a variety of publications to provide information and statistics and promote greater public understanding of its work.

The *HKMA Annual Report 2004*, published together with its summary report and an interactive website version, won a Silver Award and a Citation for Achievement in Corporate Governance Disclosure in the Hong Kong Management Association's Best Annual Reports Award. The Report was commended for "its appropriate metaphorical theme design and the novel and attractive summary version." The Report also won a bronze price in the 2005 International Annual Report Competition Awards.

The HKMA publishes its *Quarterly Bulletin* and on-line *Monthly Statistical Bulletin* as useful and easily accessible sources of information on monetary, banking and economic issues. The June and December issues of the *Quarterly Bulletin* include the HKMA's *Half-Yearly Monetary and Financial Stability Report*, which analyses the external and domestic influences on Hong Kong's monetary and financial systems.

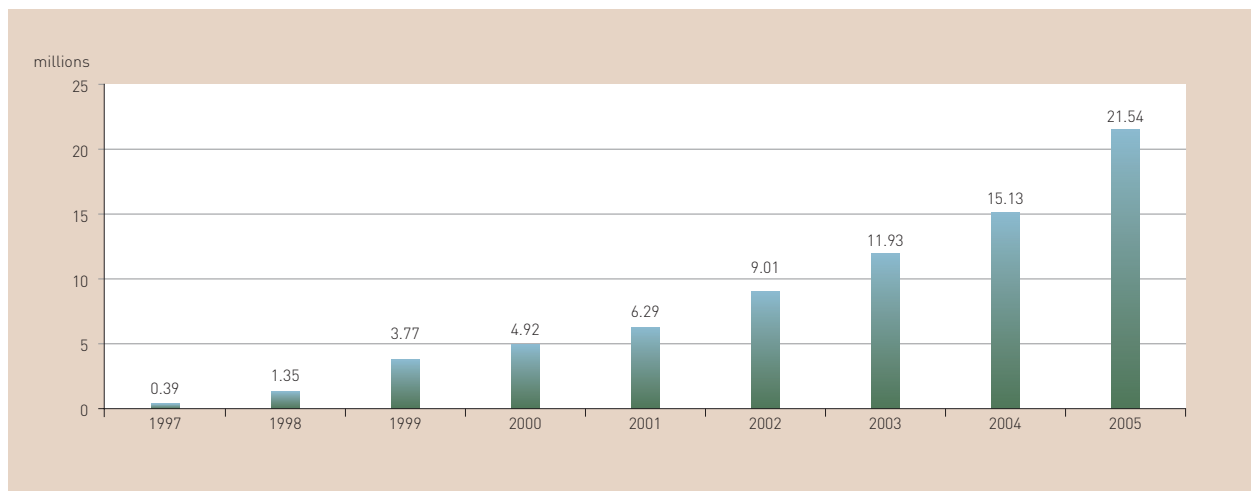
A new edition of the *HKMA Background Brief No. 1* on Hong Kong's Linked Exchange Rate System was published in November 2005, incorporating information on recent initiatives to strengthen and improve the Linked Exchange Rate system.

 > Publications

The HKMA on-line

The HKMA website www.hkma.gov.hk is a comprehensive and accessible source of news and information on the HKMA for people throughout the world. All of the main HKMA publications, together with a great deal of other information, are posted on the website. In 2005 the website received more than 21 million page views (Chart 1), an increase of 40% from 2004. Around 3,200 subscribers now receive the latest HKMA news through a daily e-mail news service.

Chart 1. Page views of the HKMA website



Public education programme

The HKMA Information Centre on the 55th floor of Two International Finance Centre plays an important role in the HKMA's public education programme. The Centre consists of an exhibition area and a library, and is open to the public six days a week.

Using interactive presentations and video montage, as well as the more traditional panels and material exhibits, the exhibition area presents a survey of the history of money and banking in Hong Kong and the key policy objectives of the HKMA. New computer programmes and interactive elements were added in 2005 to provide information about Hong Kong banknotes, Internet banking security and the payment systems of Hong Kong.



Senior citizens show great interest in the security features of banknotes.



The Information Centre is a popular destination for visits by local schools.



Mr Joseph Yam presents a souvenir to the 100,000th visitor to the Information Centre.



Mr Cheng Po-hung, a well-known local historian, leads a tour around the old banking and financial districts of Hong Kong.

The Library, situated just beyond the Exhibition Area, contains a wide range of materials about Hong Kong's monetary, banking and financial affairs and central banking topics elsewhere in the world. The main elements of the collections are publications by the HKMA and other central banks and international organisations, books and journals on monetary, banking, economics, finance and related subjects, and an electronic register of authorized institutions in Hong Kong maintained under section 20 of the Banking Ordinance.

Daily guided tours are organised for visitors. During the year, 52,000 people visited the Centre and 484 guided tours were organised for schools and other groups. A milestone was passed when the Centre received its hundred thousandth visitor in December 2005. More than 110,000 people have now visited the Centre since its opening in December 2003.

The HKMA organises regular public education seminars to explain its work. In 2005, 11 seminars were held for more than 2,000 students, teachers and members of the public. The Linked Exchange Rate system and Hong Kong's currency and banking history were the main topics of these seminars. Since the launch of the education programme in 1998, more than 30,000 students, teachers and members of the public have participated in the seminars.

 > [HKMA Information Centre](#)

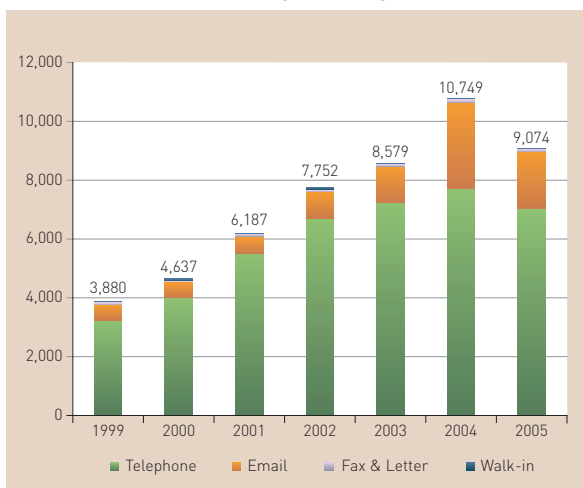


Students ask questions during a public education seminar.

Public enquiries

The HKMA received about 9,000 public enquiries in 2005 (Chart 2). The reduction in enquiries from the peak in 2004 mainly reflects the marked decrease in reports about suspected fraudulent bank e-mails and websites, following measures taken in May to strengthen the security of Internet banking. Most of the enquiries were received by telephone and came from researchers, financial professionals, students and members of the public requesting statistical or other information from the HKMA on consumer banking issues, banking and monetary policies and other HKMA-related issues. They also included complaints¹ and suggestions. The HKMA is committed to delivering speedy and informed responses to all enquirers.

Chart 2. Total number of public enquiries



HUMAN RESOURCES

The Human Resources Division provides human resources support and associated services to the HKMA.

Organisational changes and staffing

Following the departure of Mr Norman Chan in May 2005, the responsibilities at the Deputy Chief Executive level were reorganised. Mr Y K Choi, who was appointed Deputy Chief Executive (Monetary) in June 2005, assumed responsibility for monetary management, financial infrastructure, reserves management, and strategy and risk. Mr Peter Pang, Deputy Chief Executive (Development), took over responsibility for external affairs and corporate services, while retaining responsibility for research. Mr William Ryback, Deputy Chief Executive (Banking), continued to be responsible for banking policy, development and supervision.

A frozen Executive Director post was reactivated in June 2005 to enable the HKMA to focus on broad strategic planning and risk management in an increasingly complex and unpredictable financial environment. The position helps the HKMA to examine more deeply the impact on its policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change, and to develop strategic responses.

The staffing requirements arising from new or expanded activities in 2005 were met by internal redeployment or re-grading of posts. The overall establishment of the HKMA for the year remained at 604. Table 1 gives a breakdown of the establishment and strength of the HKMA at the end of 2005. In January 2006, 10 new posts were added to the HKMA establishment, representing an overall increase of 1.7%, to cater for areas of new or increased workload including prevention of money laundering, securities supervision and financial links with the Mainland.

 > [Careers @ HKMA](#)

¹ The number of complaints about banking business received by the HKMA can be found in the Banking Stability chapter.

Table 1. Establishment and strength of the HKMA

Department	Functions	2005			
		Senior staff		Others	
		Establishment	Strength	Establishment	Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	6	6
Banking Development	To formulate policies for the development of the banking industry, and to facilitate settlement for transactions executed by the HKMA for the Exchange Fund.	1	1	63	63
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	41	41
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	153	141
Office of the General Counsel	To provide in-house legal support and advice.	1	1	15	15
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through active participation in the international central banking and financial community.	1	1	47	43
Monetary Management & Infrastructure	To maintain currency stability through monitoring of market operations and development issues and developing financial market infrastructure, and to ensure adequate supply of banknotes and coins.	1	1	39	38
Research	To conduct research and analysis on economic and international financial market development, both in Hong Kong and in other economies.	1	1	31	30
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	47	46
Strategy & Risk	To examine and develop strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change.	1	1	1	1
Corporate Services	To provide support services in the form of administrative, finance, HR, IT, and secretariat services, and to handle media and community relations.	1	1	140	133
Internal Audit	To provide audit services through assisting the management in controlling risks, monitoring compliance, and improving the efficiency of internal control systems and procedures.	0	0	7	7
Total		14	14	590	564

"Senior staff" refers to staff at the Executive Director level and above.

Remuneration of senior executives

The remuneration packages of the senior executives in 2005 are shown in Table 2.

Training and development

The HKMA places great emphasis on developing staff capabilities to meet operational needs and new challenges. During 2005, HKMA staff were provided with about 2,500 training days. These included more than 800 days of general training in skills common to staff of the same rank, and 1,600 days of job-specific training. Each staff member received on average 4.19 days of training in 2005.

Table 2. Remuneration packages of HKMA senior executives in 2005

\$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff	1	4	13
Fixed pay	6,724	3,981	2,728
Variable pay	2,550	1,380	522
Other benefits	701	477	203

Notes:

- Except for annual leave accrued, the actual remuneration received by staff not serving a full year is annualised for the purpose of calculating the average annual package for the rank.
- The number of staff in this table at the Deputy Chief Executive (DCE) and Executive Director (ED) ranks reflects staff movements during the year and includes, among the EDs, the Chief Executive Officer of the Hong Kong Mortgage Corporation. The established number of posts at the DCE level is three and at the ED level eleven (including the CEO of the Hong Kong Mortgage Corporation): please see the organisation chart on page 29 for details.
- Other benefits include provident funds or gratuity as the case may be, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.

For general training, two senior staff participated in a national studies programme run by the National School of Administration of the State Council in Beijing for senior government officials of Hong Kong. Another senior staff member attended a residential programme on leadership and strategic management delivered in Hong Kong by a renowned university in the US. Four other staff members attended central banking courses offered by other central banks. In addition to these training opportunities, the HKMA provided training to staff at different levels to improve their management, language and communication skills. A central banking course was also arranged for new staff to provide them with basic central banking knowledge.

For job-specific training, the HKMA continued to arrange for staff from different departments to attend programmes offered by other central banks, multilateral organisations and other institutions. Regular briefings and workshops were arranged for front-line bank supervisors to keep abreast of the latest developments in their field. Topics covered included Basel II, the Deposit Protection Scheme, the control of money laundering, the composite interest rate and specialised banking business. During the year, a three-week induction course was arranged for the new Assistant Managers in the banking departments.

FINANCE AND ADMINISTRATION

The Finance and Administration Division aims at achieving an efficient allocation of resources within the HKMA. The administrative expenditure in 2005 and the budgeted expenditure for 2006 are shown in Table 3. In 2005 the Division continued to streamline and integrate its work to improve operational efficiency. The electronic procurement system was upgraded and an interactive voice responding system for handling external telephone calls was developed.

Table 3 Administrative expenditure (2005 and 2006 budgeted)

\$ million	2005 Budget*	2005 Actual	2006 Budget*
Staff costs	492		523
– Salaries and other staff costs		449	
– Retirement benefit costs		25	
Premises and equipment expenses			
– Operating lease charges	5	4	4
– Other premises expenses (including utility charges and management fees)	31	31	32
General operating costs			
– Maintenance of office and computer equipment	27	27	29
– Financial information and communication services (including trading, dealing terminals and data link charges)	30	28	31
– External relations (including international meetings)	16	12	18
– Professional and other services (including service fees for operating the interbank payment system)	29	23	45
– Training	5	4	4
– Others	15	13	15
TOTAL	650	616	701

* Includes supplementary budget and relevant provisions in project budgets for the year.

The HKMA back-up site was remodelled during 2005 to meet the requirements of a revised and expanded business continuity plan. A two-week drill was carried out with satisfactory results. Corporate plans were also drawn up to prepare for a possible outbreak of novel influenza.

The HKMA issued an Environmental Policy in 2001 to increase colleagues' awareness of and support for environmental protection. Since then, a number of green-office measures have been implemented and the results have been encouraging. In 2005 requests for additional air-conditioning decreased by 65%, and the number of paper hand towels used was reduced by 25%. Since 2004 the HKMA has been using only electronic greeting cards.



The HKMA Corporate Team finish fourth in the MTR Hong Kong Race Walking 2005.



Students of the Chak Yan Centre visit the HKMA Information Centre on 21 May 2005.



HKMA volunteers organise games for the Chak Yan Centre students.

The HKMA continued to support recycling. Waste paper and used printer cartridges were collected for recycling. Old chairs were donated to charitable organisations. Regular campaigns were held to collect unwanted clothes, toys and other reusable items from staff for donation to charities.

During 2005, the HKMA participated in various community events and fund-raising activities. In February an HKMA team participated in the Hong Kong Marathon and the Green Power Hike. In the MTR Hong Kong Race Walking held on 3 April, the HKMA Team came fourth among 39 participating corporations. Forty-one staff took part in the Hong Kong Red Cross blood donation day in May. Staff also participated in various other fund-raising activities such as the Community Chest's Skip Lunch Day, Green Day and Dress Casual Day.

Members of the HKMA Volunteer Team gave more than 110 hours of their free time to voluntary service during 2005. They arranged for the students of the Chak Yan Centre to visit the HKMA in May, assisted the Airport Authority to conduct an emergency drill in June, and helped to organise activities, with environment-protection themes, to raise donations for the pupils in Liannan, one of the mountainous areas of Guangdong, inhabited by the minority Yao people.

INFORMATION TECHNOLOGY

The HKMA back-up computer centre was expanded and remodelled in April 2005 to meet operational needs in the next three to five years. In July 2005, the Exchange Fund Advisory Committee (EFAC) endorsed a comprehensive IT upgrade programme covering PCs, printers, the file-and-print system, the e-mail and workflow system, IT security systems, the SWIFT system (a financial industry-owned

co-operative messaging and interface software), and banking supervision applications. The programme is expected to be completed in 2007. To prepare for the implementation of Basel II, a feasibility study of the processing of new banking returns was carried out and a project plan developed in 2005. System enhancement work commenced in early 2006. In 2005, the Submission Through Electronic Transmission (STET) system was upgraded to improve the efficiency of electronic statutory submissions by the authorized institutions. A secure e-mail communication channel within the STET network for day-to-day communication between the HKMA and authorized institutions has been established. This channel will gradually replace the existing Internet connection. The CMU Bond Price Bulletin, which disseminates the indicative bid/offer prices of fixed-income instruments provided by a number of banks, was developed in 2005 and launched in January 2006.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel (OGC) advises the HKMA on the legal aspects of all of the HKMA's activities. The OGC's lawyers are involved at an early stage in the planning and implementation of the HKMA's projects, initiatives and operations.

In addition to its general operational workload, the OGC was involved in a number of projects in 2005, including the preparation of the Rules to be issued under the Banking (Amendment) Ordinance 2005 and the Deposit Protection Scheme Ordinance, for the implementation of the Basel II capital accord in Hong Kong and the specification of asset maintenance requirements for the Scheme's member banks respectively, the launch of Asian Bond Fund 2, and the implementation of the Clearing and Settlement Systems Ordinance. The OGC also advised on a number of other projects, including the establishment of the Treasury Markets Association, the expansion of the scope of renminbi banking business conducted in Hong Kong, and several bank mergers and bank restructurings.

During the year, lawyers of the OGC participated in meetings and conferences for central bankers and their legal advisers to keep abreast of topical developments in important international financial centres. These conferences covered issues such as money laundering, electronic financial infrastructure, banking supervision and central bank governance. OGC lawyers also took part in a series of teleconferences with their counterparts from central banks and international legal think-tanks to clarify and resolve topics of current concern. Presentations were made by lawyers of the OGC at professional seminars and universities (both local and overseas) on subjects ranging from corporate governance issues for banks, payment and settlement systems, anti-money laundering measures and prevention of terrorist financing.

INTERNAL AUDIT

The Internal Audit Division was established in 1995 to assist management in accomplishing organisational objectives by independently reviewing and evaluating the effectiveness of risk management, control and governance processes, and advising on opportunities for improvement. The role, mission and authority of the Division are defined in the Internal Audit Charter granted by the Chief Executive of the HKMA. The Charter is available on the HKMA website. The Division reports directly to the Chief Executive of the HKMA and the EFAC Audit Sub-Committee.

Audit work performed in 2005

The Division continued to operate independently and effectively throughout the year. Co-ordinated by the Division, line management of all business divisions carried out the annual update of their risk assessments to identify and assess risks and corresponding controls in their operations. Based on the risk profiles of individual business units, the Division prepared an audit plan in which all the significant risks were adequately and systematically covered. The Division also analysed

the results of the assessments to facilitate review by senior management and the Risk Committee.

In 2005 internal audit assignments carried out by the Division covered monetary operations, reserves management, settlement operations, security arrangements of critical IT system and other important corporate services. In addition, the Division advised on IT system development projects and performed ad hoc reviews at the request of senior management. The results of the audits conducted in 2005 were satisfactory. Recommendations for improvement put forward by the Division were well received and implemented by auditees.

The Division attaches great importance to keeping abreast of the developments of the internal auditing standard and the practices adopted by other central banks. During the year, Division staff attended an international conference of the heads of internal audit of central banks and monetary authorities organised by the Bank for International Settlements. They also met with the internal auditors of other central banks and financial institutions to exchange views and share experience in risk management and internal audit approaches. Training courses and seminars on risk management, audit techniques, management and language skills were arranged for the professional staff of the Division to facilitate the performance of audits and career development.

 > Internal Audit

RISK MANAGEMENT

One of the most important tasks of the HKMA is to manage risks to the monetary and banking systems. Risk management is undertaken both at a working level in the day-to-day operations of the HKMA and at a higher level through strategic planning. Reflecting developments in risk management practices in the financial sector, a number of improvements to corporate risk management in the HKMA were introduced in 2005.

An internal, high-level Risk Committee was established in early 2005. The Committee is chaired by the Chief Executive and the three Deputy Chief Executives serve as members. The functions of the Risk Committee are to

- identify potential risks and threats to the organisation and the monetary and financial systems more broadly, and devise strategies to reduce the impact of these risks and threats
- review the existing systems for managing risks across different departments to identify possible gaps and significant risks, and ensure the adequacy of measures to address them
- harmonise the criteria and methods of risk measurement and prioritise the resource management of risks identified
- encourage a stronger risk management culture which promotes the proper levels of authorisation and controls.

The Risk Committee provides direction and assistance for senior management in managing risk in the HKMA's operations. It meets regularly to review the risk assessments made by different business units and the adequacy of related controls, as well as to identify potential or emerging risks and devise strategies to mitigate them. In 2005, the Committee examined a number of major risks including the potential disruption to business continuity of critical facilities in the monetary and banking sectors in the event of disturbances associated with the World Trade Organization Ministerial Conference in Hong Kong and the potential threat to banking and monetary stability in the event of an outbreak of avian influenza.

CALENDAR OF EVENTS 2005

APRIL
25

The Hongkong and Shanghai Banking Corporation Limited is re-appointed as Settlement Institution for the US dollar clearing system in Hong Kong for a second five-year period.

MAY
3

The HKMA announces the issue of up to \$300 million of two-year Exchange Fund Notes for retail investors, the first under a refined Exchange Fund Notes Programme.

MAY
18

Three refinements to the operation of the Linked Exchange Rate system are introduced. The refinements are aimed at removing uncertainty about the extent to which the exchange rate might strengthen under the Linked Exchange Rate system and promoting the smooth functioning of the money and foreign exchange markets in accordance with Currency Board arrangements.

MAY
30

The HKMA, the Hong Kong Association of Banks and the Hong Kong Police Force jointly announce the launch of two-factor authentication for Internet banking by the banking industry.

JUNE
1

Mr Y K Choi is appointed Deputy Chief Executive of the HKMA, following the departure of Mr Norman Chan in May.

JUNE
21

The ABF Hong Kong Bond Index Fund, the first bond fund under Asian Bond Fund 2, is listed in Hong Kong.

JULY
6

The Legislative Council passes the Banking (Amendment) Ordinance 2005. The main purpose of the Ordinance is to amend the Banking Ordinance to provide a legislative framework for the implementation of Basel II in Hong Kong.

JULY
7

The Pan Asia Bond Index Fund under Asian Bond Fund 2 is listed in Hong Kong.

JULY
21

The renminbi exchange regime is moved to a managed floating rate system based on market supply and demand with reference to a basket of currencies. The renminbi is no longer pegged to the US dollar. There is an initial adjustment to RMB8.11 yuan per US dollar, representing a 2% appreciation.

SEPTEMBER
16

The Monetary Authority, on the advice of the Financial Secretary, appoints Mr Paul Jeremy Brough of KPMG under section 52(1)(C) of the Banking Ordinance, to be the Manager for the time being of Delta Asia Credit Limited. Delta Asia Credit Limited is a deposit-taking company in Hong Kong authorized under the Banking Ordinance and a subsidiary of Banco Delta Asia S.A.R.L. in Macau. The Monetary Authority's primary direction to the Manager is to conserve the assets of Delta Asia Credit Limited and restrict any increase in its liabilities pending the outcome of investigations or other actions by the Macau authorities.

NOVEMBER
1

The HKMA announces the details of the expansion of renminbi business in Hong Kong previously announced in the Chief Executive's Policy Address. The measures include: expanding the definition of designated merchants and allowing such merchants to open renminbi deposit accounts; allowing Hong Kong residents to use renminbi cheques in Guangdong Province; relaxing limits for exchange and remittance of renminbi by individuals; and removing the cap on credit limits for renminbi cards issued by participating banks.

NOVEMBER
8

The International Monetary Fund Staff Mission to Hong Kong completes its Article IV Consultation, stating that it is supportive of the Government's fiscal policy and its commitment to the Linked Exchange Rate system.

DECEMBER
8

The HKMA releases a new data series on a composite interest rate. The new series is introduced following research which concluded that a composite interest rate, reflecting movements in various deposit rates, interbank and other interest rates, closely tracked the average cost of funds of authorized institutions over the past six years. The publication of the composite interest rate is to help improve interest rate risk management in the banking sector.

DECEMBER
8

Bank Negara Malaysia and the HKMA sign a Memorandum of Understanding for the establishment of a large-value payment-system link between the ringgit RTGS system in Malaysia and the US dollar RTGS system in Hong Kong. This link, scheduled to be completed in 2006, is the first cross-border payment-versus-payment link between two RTGS systems for two currencies in Asia.

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ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES at 31.12.2005

Licensed Banks

Incorporated in Hong Kong

Asia Commercial Bank Limited	Dah Sing Bank Limited	MEVAS Bank Limited
Bank of America (Asia) Limited	DBS BANK (HONG KONG) LIMITED	Nanyang Commercial Bank, Limited
Bank of China (Hong Kong) Limited	FUBON BANK (HONG KONG) LIMITED (formerly known as: International Bank of Asia Limited)	Shanghai Commercial Bank Limited
Bank of East Asia, Limited (The)	Hang Seng Bank, Limited	Standard Bank Asia Limited
CHINA CONSTRUCTION BANK (ASIA) LIMITED (formerly known as: JIAN SING BANK LIMITED)	Hongkong & Shanghai Banking Corporation Limited (The)	Standard Chartered Bank (Hong Kong) Limited
Chiyu Banking Corporation Limited	Industrial and Commercial Bank of China (Asia) Limited	Tai Sang Bank Limited
CITIBANK (HONG KONG) LIMITED	Liu Chong Hing Bank Limited	Tai Yau Bank, Limited
CITIC Ka Wah Bank Limited		WING HANG BANK, LIMITED
		Wing Lung Bank Limited

Incorporated outside Hong Kong

ABN AMRO Bank N.V.	Bank of India	Chiba Bank, Ltd. (The)
Agricultural Bank of China	Bank of Montreal	China Construction Bank Corporation
American Express Bank Limited	Bank of New York (The)	China Merchants Bank Co., Ltd.
Australia & New Zealand Banking Group Limited	Bank of Nova Scotia (The)	Chinatrust Commercial Bank, Ltd.
BANCA DI ROMA, SOCIETA' PER AZIONI	BANK OF TAIWAN	Chugoku Bank, Ltd. (The)
Banca Intesa S.p.A. also known as: Intesa S.p.A.	Bank of Tokyo-Mitsubishi, Ltd. (The)	Citibank, N.A.
Banca Monte dei Paschi di Siena S.p.A.	Bank SinoPac	Commerzbank AG
Banca Nazionale del Lavoro S.p.A.	Barclays Bank plc	Commonwealth Bank of Australia
Banco Bilbao Vizcaya Argentaria S.A.	Bayerische Hypo-und Vereinsbank Aktiengesellschaft	Coöperatieve Centrale Raiffeisen- Boerenleenbank B.A.
Bangkok Bank Public Company Limited	Bayerische Landesbank	Coutts Bank von Ernst AG also known as: Coutts Bank von Ernst SA Coutts Bank von Ernst Ltd
Bank Melli Iran	BNP PARIBAS	Credit Suisse also known as: Crédit Suisse Credito Svizzero Schweizerische Kreditanstalt
Bank of America, National Association	BNP PARIBAS PRIVATE BANK	DBS BANK LTD.
Bank of China Limited	Canadian Imperial Bank of Commerce	
Bank of Communications Co., Ltd. (formerly known as: Bank of Communications)	CALYON	
	CATHAY UNITED BANK COMPANY, LIMITED	
	Chang Hwa Commercial Bank Ltd.	

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES at 31.12.2005 (cont.)

Deutsche Bank Aktiengesellschaft	ING Bank N.V.	State Bank of India
DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main	Iyo Bank, Ltd. (The)	State Street Bank and Trust Company
E.Sun Commercial Bank, Ltd.	JPMorgan Chase Bank, National Association	Sumitomo Mitsui Banking Corporation
EFG Private Bank SA	KBC Bank N.V.	Svenska Handelsbanken AB (publ)
Equitable PCI Bank, Inc.	Korea Exchange Bank	TAIPEI FUBON COMMERCIAL BANK CO., LTD. (formerly known as: TAIPEIBANK Co., Ltd.)
Erste Bank der oesterreichischen Sparkassen AG	Landesbank Baden-Württemberg (Licence transfer from Baden-Württembergische Bank Aktiengesellschaft)	TAISHIN INTERNATIONAL BANK CO., LTD
FAR EASTERN INTERNATIONAL BANK#	Malayan Banking Berhad	Taiwan Business Bank
First Commercial Bank, Ltd.	MELLI BANK PLC#	Toronto-Dominion Bank (The)
Fortis Bank	Mitsubishi UFJ Trust and Banking Corporation (formerly known as Mitsubishi Trust and Banking Corporation (The))	UBS AG also known as: UBS SA UBS Ltd
Governor and Company of the Bank of Scotland (The)	Mizuho Corporate Bank, Ltd.	UCO Bank
Hachijuni Bank, Ltd. (The)	Natexis Banques Populaires	UFJ Bank Limited
HANA BANK	National Australia Bank Limited	UniCredito Italiano Societa' per Azioni
HONG LEONG BANK BERHAD	National Bank of Pakistan	UNITED COMMERCIAL BANK
HSBC BANK INTERNATIONAL LIMITED	Oversea-Chinese Banking Corporation Limited	United Overseas Bank Ltd.
HSBC Bank plc	Philippine National Bank	Wells Fargo Bank, National Association
HSBC Bank USA, National Association	PT. Bank Negara Indonesia (Persero) Tbk.	WestLB AG
HSBC Private Bank (Suisse) SA	Public Bank Berhad	Westpac Banking Corporation
HSH Nordbank AG	Royal Bank of Canada	Woori Bank
Hua Nan Commercial Bank, Ltd.	Royal Bank of Scotland public limited company (The)	
ICICI BANK LIMITED#	SANPAOLO IMI S.p.A.	Deletion in 2005
Indian Overseas Bank	Shiga Bank, Ltd. (The)	BELGIAN BANK
Industrial and Commercial Bank of China Limited (formerly known as: Industrial and Commercial Bank of China (The))	Shinkin Central Bank	Credit Lyonnais
INTERNATIONAL BANK OF TAIPEI	Shizuoka Bank, Ltd. (The)	Fleet National Bank
INTERNATIONAL COMMERCIAL BANK OF CHINA CO., LTD. (THE)	Societe Generale	
	Standard Chartered Bank	

ANNEX: AUTHORIZED INSTITUTIONS AND LOCAL REPRESENTATIVE OFFICES at 31.12.2005 (cont.)

Restricted Licence Banks

Incorporated in Hong Kong

ABSA BANK (ASIA) LIMITED
AIG Finance (Hong Kong) Limited
ALLIED BANKING CORPORATION
(HONG KONG) LIMITED
Banc of America Securities Asia
Limited
Bank of Baroda (Hong Kong)
Limited
BOCI Capital Limited
Citicorp International Limited
GE Capital (Hong Kong) Limited
Indover bank (Asia) Limited
Industrial and Commercial
International Capital Limited

J. P. MORGAN SECURITIES (ASIA
PACIFIC) LIMITED
KDB Asia Limited
KOOKMIN BANK HONG KONG
LIMITED
Mitsubishi UFJ Securities (HK)
Capital, Limited
(formerly known as: Mitsubishi
Securities (HK), Limited)
ORIX Asia Limited
Pacific Finance (Hong Kong)
Limited
SCOTIABANK (HONG KONG)
LIMITED

Shinhan Finance Limited
Societe Generale Asia Limited
UBAF (Hong Kong) Limited

Deletion in 2005

Canadian Eastern Finance
Limited
Citicorp Commercial Finance
(H.K.) Limited
Hang Seng Finance Limited
MIZUHO CORPORATE ASIA (HK)
LIMITED
N. M. ROTHSCHILD & SONS
(HONG KONG) LIMITED

Incorporated outside Hong Kong

Bank of Ayudhya Public Company
Limited
Bumiputra-Commerce Bank
Berhad
Dexia Banque Internationale à
Luxembourg
HYPO REAL ESTATE BANK
INTERNATIONAL
Industrial Bank of Korea
Lloyds TSB Bank Plc
Mashreq Bank – Public
Shareholding Company
also known as:
Mashreqbank psc

PT. BANK MANDIRI (PERSERO)
Tbk
Siam Commercial Bank Public
Company Limited (The)
Thanakharn Kasikorn Thai
Chamkat (Mahachon)
also known as:
KASIKORNBANK PUBLIC
COMPANY LIMITED
TMB Bank Public Company
Limited
(formerly known as: Thai
Military Bank Public Company
Limited)

Union Bank of California, National
Association
Wachovia Bank, National
Association

Deletion in 2005

Bank of Bermuda, Limited (The)
NEDBANK LIMITED

**ANNEX: AUTHORIZED INSTITUTIONS AND
LOCAL REPRESENTATIVE OFFICES** at 31.12.2005 (cont.)**Deposit-taking Companies*****Incorporated in Hong Kong***

Argo Enterprises Company Limited	Gunma Finance (Hong Kong) Limited	Michinoku Finance (Hong Kong) Limited
BCOM Finance (Hong Kong) Limited	Habib Finance International Limited	OCTOPUS CARDS LIMITED
BII Finance Company Limited	Hachijuni Asia Limited	Orient First Capital Limited
BPI International Finance Limited	HBZ Finance Limited	PrimeCredit Limited
Chau's Brothers Finance Company Limited	Henderson International Finance Limited	Shacom Finance Limited
Chohung Finance Limited	HKCB Finance Limited	Sumitomo Trust Finance (H.K.) Limited (The)
Commonwealth Finance Corporation Limited	Hung Kai Finance Company Limited	Vietnam Finance Company Limited
Corporate Finance (D.T.C.) Limited	Inchroy Credit Corporation Limited	Wing Hang Finance Company Limited
Delta Asia Credit Limited	Indo Hong Kong International Finance Limited	Wing Lung Finance Limited
Edward Wong Credit Limited	JCG Finance Company, Limited	
First Metro International Investment Company Limited	KEXIM ASIA LIMITED	Deletion in 2005
FUBON CREDIT (HONG KONG) LIMITED (formerly known as: IBA Credit Limited)	Liu Chong Hing Finance Limited	C.F. Finance Company Limited
		Korea First Finance Limited

Incorporated outside Hong Kong

NIL

Local Representative Offices

AIG Private Bank Ltd.	Banca Popolare di Ancona Società per azioni	Banco do Brasil S.A.
ANTWERPSE DIAMANTBANK NV also known as: ANTWERP DIAMOND BANK NV	Banca Popolare di Bergamo S.p.A.	Banco Popolare di Verona e Novara S.c.r.l.
Arab Bank plc	Banca Popolare di Novara – Società per Azioni	Banco Popular Español, S.A.
Banca Antoniana-Popolare Veneta S.C.A R.L.	Banca Popolare di Sondrio Soc. Coop. a r.l.	Banco Santander Central Hispano, S.A.
Banca del Gottardo	Banca Popolare di Vicenza Soc. Coop. a r.l.	Bank für Arbeit und Wirtschaft Aktiengesellschaft
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Banco de Crédito e Inversiones#	Bank Hapoalim (Switzerland) Ltd#
		Bank Leumi Le-Israel B.M.

Addition in 2005

**ANNEX: AUTHORIZED INSTITUTIONS AND
LOCAL REPRESENTATIVE OFFICES at 31.12.2005 (cont.)**

Bank of Fukuoka, Ltd. (The)	HSBC Bank Australia Limited	Raiffeisen Zentralbank Osterreich AG
Bank of Kyoto, Ltd. (The)	HSBC Bank Canada	Resona Bank, Limited
Bank of New York – Inter Maritime Bank, Geneva	HSBC Guyerzeller Bank AG	Rothschild Bank AG
Bank of Yokohama, Ltd. (The)	HSBC Trinkaus & Burkhardt (International) S.A.	Schroder & Co Bank AG also known as: Schroder & Co Banque SA Schroder & Co Banca SA Schroder & Co Bank Ltd Schroder & Co Banco SA
Banque Privee Edmond de Rothschild S.A.	HSH Nordbank Private Banking S.A.#	Shanghai Pudong Development Bank Co., Ltd.
BARCLAYS BANK (SUISSE) S.A.#	Investec Bank Limited	Shenzhen Development Bank Co., Ltd.
BSI Ltd.	Japan Bank for International Cooperation	Shoko Chukin Bank (The)
CARIPRATO – Cassa di Risparmio di Prato S.p.A.	Juroku Bank, Ltd. (The)	Standard Bank of South Africa Ltd. (The)
Cathay Bank	Kagoshima Bank Ltd. (The)	STANDARD CHARTERED (JERSEY) LIMITED
China Development Bank	Korea Development Bank (The)	Taiwan Cooperative Bank
China Everbright Bank Co., Ltd	Kredietbank S.A. Luxembourgeoise	UFJ Bank (Schweiz) AG also known as: UFJ Bank (Switzerland) Ltd. UFJ Banque (Suisse) SA UFJ Banca (Svizzera) SA
CHINA MINSHENG BANKING CORPORATION LIMITED	Land Bank of Taiwan	Union Bank of Taiwan
Chinese Bank (The)	LGT Bank in Liechtenstein AG also known as: LGT Bank in Liechtenstein Ltd. LGT Banque de Liechtenstein S.A. LGT Banca di Liechtenstein S.A.	Veneto Banca S.c.a.r.l.
CITIC Group	LLOYDS TSB OFFSHORE LIMITED	Yamaguchi Bank, Ltd. (The)
Clariden Bank	Merrill Lynch Bank (Suisse) S.A.	Yamanashi Chuo Bank, Ltd.
CLEARSTREAM BANKING S.A. (formerly known as: Clearstream Banking)	Merrill Lynch International Bank Limited	
Credit Industriel et Commercial	Metropolitan Bank and Trust Company	
Credito Bergamasco S.p.A.	Nanto Bank, Ltd. (The)	
D.A.H. Hambros Bank (Channel Islands) Limited	National Bank of Canada	
DePfa Investment Bank Limited	Nishi-Nippon Bank, Ltd. (The)	
DVB Bank N.V.	Norinchukin Bank (The)	
eBANK Corporation#	Ogaki Kyoritsu Bank, Ltd. (The)	
Euroclear Bank	Oita Bank, Ltd. (The)	
Fiduciary Trust Company International	P.T. Bank Central Asia	
Fuhwa Commercial Bank Co., Ltd.	P.T. Bank Rakyat Indonesia (Persero)	
GUANGDONG DEVELOPMENT BANK CO., LTD.		
Habib Bank A.G. Zurich		

Deletion in 2005

Banque Cantonale Vaudoise
EFG PRIVATE BANK LIMITED
Far Eastern International Bank
GERRARD PRIVATE BANK
(JERSEY) LIMITED

TABLE A: MAJOR ECONOMIC INDICATORS

	2001	2002	2003	2004	2005
I. Gross Domestic Product					
Real GDP growth (%)	0.6	1.8	3.2	8.6	7.3 ^(a)
Nominal GDP growth (%)	-1.2	-1.7	-3.4	4.7	7.0 ^(a)
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	2.1	-1.0	-0.9	7.3	3.7 ^(a)
– Government consumption expenditure	6.0	2.5	1.9	0.7	-3.0 ^(a)
– Gross domestic fixed capital formation of which	2.6	-4.5	0.9	3.0	3.9 ^(a)
– Building and construction	-1.1	-1.1	-5.6	-11.7	-6.8 ^(a)
– Machinery, equipment and computer software	6.2	-7.6	6.7	11.0	10.7 ^(a)
– Exports	-1.7	9.1	13.1	15.8	10.7 ^(a)
– Imports	-1.5	7.5	11.5	14.2	8.1 ^(a)
GDP at current market prices (US\$ billion)	166.5	163.7	158.5	165.8	177.7 ^(a)
Per capita GDP at current market prices (US\$)	24,764	24,121	23,293	24,096	25,625 ^(a)
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	153.5	131.1	122.1	126.4	136.3 ^(a)
– Re-exports of goods	1,327.5	1,431.0	1,627.0	1,900.6	2,115.4 ^(a)
– Total imports of goods	1,549.2	1,601.5	1,794.1	2,099.5	2,311.1 ^(a)
– Merchandise trade balance	-68.2	-39.4	-45.0	-72.5	-59.3 ^(a)
Services trade					
– Exports of services	320.8	347.8	362.4	429.6	479.5 ^(a)
– Imports of services	194.2	202.5	203.4	242.5	252.4 ^(a)
– Services trade balance	126.6	145.3	159.0	187.1	227.1 ^(a)
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure	238,890	239,177	247,466	242,235	237,609 ^(a)
Total government revenue	175,559	177,489	207,338	263,591	241,666 ^(a)
Consolidated surplus/deficit	-63,331	-61,688	-40,128	21,356	4,057 ^(a)
Reserve balance as at end of fiscal year ^(c)	372,503	311,402	275,343	295,981	300,756 ^(a)
IV. Prices (annual change, %)					
Consumer Price Index (A)	-1.7	-3.2	-2.1	0.0	1.2
Composite Consumer Price Index	-1.6	-3.0	-2.6	-0.4	1.1
Trade Unit Value Indices					
– Domestic exports	-4.7	-3.3	0.2	1.5	2.2
– Re-exports	-2.0	-2.7	-1.5	1.1	1.2
– Imports	-3.1	-3.9	-0.4	2.9	2.7
Property Price Indices					
– Residential flats	-12	-11	-12	27	18 ^(a)
– Office premises	-12	-13	-9	59	34 ^(a)
– Retail premises	-7	-2	1	40	23 ^(a)
– Flatted factory premises	-10	-9	-4	24	40 ^(a)

TABLE A: MAJOR ECONOMIC INDICATORS (cont.)

	2001	2002	2003	2004	2005
V. Labour					
Labour force (annual change, %)	1.6	1.8	0.3	1.6	1.0
Employment (annual change, %)	1.4	-0.6	-0.4	2.8	2.3
Unemployment rate (annual average, %)	5.1	7.3	7.9	6.8	5.6
Underemployment rate (annual average, %)	2.5	3.0	3.5	3.3	2.8
Employment ('000)	3,252	3,232	3,219	3,309	3,386
of which					
– Manufacturing	326	290	272	236	228
– Financing, insurance, real estate and business services	478	474	470	482	506
– Wholesale, retail and import/export trades, restaurants and hotels	981	983	992	1,074	1,111
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	229.8	259.4	354.8	412.6	348.2
– M2 ^(d)	1,998.8	1,984.0	2,107.3	2,208.6	2,329.7
– M3 ^(d)	2,016.6	2,004.2	2,122.9	2,219.6	2,345.9
Total money supply					
– M1	258.1	295.6	413.4	484.5	434.7
– M2	3,550.1	3,518.3	3,813.4	4,166.7	4,379.1
– M3	3,594.1	3,561.9	3,858.0	4,189.5	4,407.2
VII. Interest Rates (end of period, %)					
Three-month interbank rate	1.88	1.41	0.07	0.28	4.16
Savings deposit	0.15	0.03	0.01	0.01	2.32
One-month time deposit	0.54	0.13	0.01	0.02	2.68
Banks' 'Best lending rate'	5.13	5.00	5.00	5.00	7.75
Banks' 'Composite rate'	N.A.	N.A.	0.24	0.30	2.88
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.797	7.798	7.763	7.774	7.753
Trade-weighted Effective Exchange Rate Index (Jan 2000=100)	105.9	102.0	98.8	96.0	98.4
IX. Foreign Currency Reserve Assets (US\$ billion) ^(e)					
	111.2	111.9	118.4	123.6	124.3
X. Stock Market (end of period)					
Hang Seng Index	11,397	9,321	12,576	14,230	14,876
Average price/earning ratio	12.2	14.9	19.0	18.7	15.6
Market capitalisation (HK\$ billion)	3,885.3	3,559.1	5,477.7	6,629.2	8,113.3

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes changes in provision for loss in investments with the Exchange Fund.

(d) Adjusted to include foreign currency swap deposits.

(e) Excludes unsettled forward transactions but includes gold.

N.A. Not Applicable

TABLE B: PERFORMANCE RATIOS OF THE BANKING SECTOR ^(a)

	All AIs				
	2001	2002	2003	2004	2005
Asset Quality ^(b)	%	%	%	%	%
As % of total credit exposures ^(c)					
Total outstanding provisions/impairment allowances	1.73	1.40	1.14	0.78	0.49
Classified ^(d) exposures:					
Gross	3.71	2.77	2.25	1.22	0.82
Net of specific provisions/individual impairment allowances	2.47	1.85	1.54	0.81	0.54
Net of all provisions/impairment allowances	1.98	1.37	1.10	0.44	0.33
As % of total loans					
Total outstanding provisions/impairment allowances	2.82	2.39	1.98	1.42	0.87
Classified ^(d) loans:					
Gross	5.73	4.53	3.74	2.11	1.35
Net of specific provisions/individual impairment allowances	3.75	2.98	2.54	1.40	0.87
Net of all provisions/impairment allowances	2.92	2.13	1.76	0.70	0.48
Overdue > 3 months and rescheduled loans	4.16	3.41	2.81	1.54	0.94
Profitability					
Return on assets (operating profit)	0.85	0.94	0.93	1.06	1.07
Return on assets (post-tax profit)	0.76	0.81	0.81	0.97	0.96
Net interest margin	1.45	1.52	1.41	1.18	1.18
Cost-income ratio	47.2	46.3	45.8	48.7	50.6
Bad debt charge to total assets	0.23	0.24	0.24	0.01	0.01
Liquidity					
Loan to deposit ratio (all currencies)	64.1	62.6	57.1	55.8	56.8
Loan to deposit ^(e) ratio (Hong Kong dollar)	88.8	88.5	81.5	82.6	84.3

Asset Quality

Delinquency ratio of residential mortgage loans
Credit card receivables
 Delinquency ratio
 Charge-off ratio

Profitability

Operating profit to shareholders' funds
Post-tax profit to shareholders' funds

Capital Adequacy

Equity to assets ratio ^(b)

Capital adequacy ratio (consolidated)

(a) Figures relate to Hong Kong office(s) only except where otherwise stated.

(b) Figures relate to Hong Kong office(s) and for the locally incorporated AIs included therein, also their overseas branches.

(c) Credit exposures include loans & advances, acceptances & bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

(e) Includes swap deposits.

Retail Banks				
2001	2002	2003	2004	2005
%	%	%	%	%
1.76	1.41	1.13	0.77	0.43
4.03	3.02	2.32	1.27	0.82
2.85	2.15	1.67	0.91	0.60
2.27	1.61	1.18	0.50	0.39
3.04	2.49	2.05	1.45	0.78
6.53	5.04	3.94	2.25	1.38
4.51	3.53	2.78	1.59	0.98
3.48	2.55	1.89	0.80	0.59
4.57	3.59	2.87	1.48	0.92
1.17	1.35	1.36	1.52	1.55
1.05	1.18	1.18	1.39	1.40
2.03	2.09	1.91	1.66	1.68
42.2	39.3	38.6	41.4	41.9
0.40	0.34	0.29	-0.02	-0.01
53.7	53.5	49.5	50.0	53.2
77.2	78.6	71.6	73.2	78.8
Surveyed Institutions				
2001	2002	2003	2004	2005
%	%	%	%	%
1.22	1.06	0.86	0.38	0.19
1.28	1.28	0.92	0.44	0.37
5.46	13.25	10.02	4.73	2.81
Locally Incorporated Banks				
2001	2002	2003	2004	2005
%	%	%		
15.4	16.2	16.9	18.7	18.4
14.1	14.0	14.6	17.2	16.6
10.5	10.6	10.5	10.6	8.2
Locally Incorporated AIs				
2001	2002	2003	2004	2005
%	%	%	%	%
16.5	15.7	15.3	15.4	14.9

TABLE C: AUTHORIZED INSTITUTIONS: DOMICILE AND PARENTAGE

	2001	2002	2003	2004	2005
Licensed Banks					
(i) Incorporated in Hong Kong	29	26	23	24	24
(ii) Incorporated outside Hong Kong	118	107	111	109	109
Total	147	133	134	133	133
Restricted Licence Banks					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	2	2	1	1	0
(b) incorporated outside Hong Kong	11	12	11	10	8
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	30	26	24	23	21
(iii) Bank related	3	3	3	3	1
(iv) Others	3	3	3	3	3
Total	49	46	42	40	33
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	15	14	9	7	6
(b) incorporated outside Hong Kong	5	4	3	2	2
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	21	15	15	14	13
(iii) Bank related	2	2	2	2	3
(iv) Others	11	10	10	10	9
Total	54	45	39	35	33
All Authorized Institutions	250	224	215	208	199
Local Representative Offices	111	94	87	85	86

**TABLE D: AUTHORIZED INSTITUTIONS:
REGION/ECONOMY OF BENEFICIAL OWNERSHIP**

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	01	02	03	04	05	01	02	03	04	05	01	02	03	04	05
Asia & Pacific															
Hong Kong	14	12	13	12	12	2	2	1	1	1	15	14	13	12	11
Australia	4	4	4	4	4	-	-	-	-	-	-	-	-	-	-
Mainland China	19	13	12	13	12	2	2	2	2	2	3	3	3	2	2
India	4	4	4	4	5	-	1	1	1	1	3	2	2	2	2
Indonesia	2	1	1	1	1	2	2	2	2	2	4	2	2	1	1
Japan	20	15	13	12	12	5	4	4	4	3	7	7	5	4	4
Malaysia	1	1	2	3	3	2	2	1	1	1	1	1	1	1	1
Pakistan	1	1	1	1	1	-	-	-	-	-	2	2	2	2	2
Philippines	2	2	2	2	2	1	1	1	1	1	4	3	3	3	3
Singapore	7	6	4	4	4	1	-	-	-	-	3	2	-	-	-
South Korea	3	3	3	3	3	6	5	5	4	4	2	1	1	2	2
Taiwan	7	10	13	14	15	1	2	-	-	-	-	-	-	1	1
Thailand	1	1	1	1	1	4	4	4	4	4	-	-	-	-	-
Vietnam	-	-	-	-	-	-	-	-	-	-	1	1	1	1	1
Sub-Total	85	73	73	74	75	26	25	21	20	19	45	38	33	31	30
Europe															
Austria	2	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Belgium	4	3	3	2	2	-	-	-	-	-	-	-	-	-	-
Denmark	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	5	6	6	6	5	3	3	2	2	2	-	-	-	-	-
Germany	9	9	9	8	8	1	-	-	1	1	-	-	-	-	-
Italy	6	6	6	6	6	-	-	-	-	-	-	-	-	-	-
Netherlands	3	3	3	3	3	-	-	-	-	-	-	-	-	-	-
Spain	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Sweden	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Switzerland	3	3	3	3	3	1	1	1	1	0	-	-	-	-	-
United Kingdom	10	10	9	10	10	2	2	2	1	1	-	-	-	-	-
Sub-Total	44	43	42	41	40	7	6	5	5	4	-	-	-	-	-
Middle East															
Bahrain	1	1	1	0	0	-	-	-	-	-	1	1	1	0	0
Iran	1	1	1	1	2	-	-	-	-	-	-	-	-	-	-
U.A.E.	-	-	-	-	-	-	-	1	1	1	1	1	1	0	0
Sub-Total	2	2	2	1	2	-	-	1	1	1	2	2	2	0	0
North America															
Canada	5	4	5	5	5	2	2	2	2	1	-	-	-	-	-
United States	10	10	11	11	10	9	9	9	8	6	5	3	3	3	2
Sub-Total	15	14	16	16	15	11	11	11	10	7	5	3	3	3	2
South Africa	1	1	1	1	1	3	2	2	2	1	1	1	-	-	-
Bermuda	-	-	-	-	-	2	2	1	1	0	-	-	-	-	-
Others	-	-	-	-	-	-	-	1	1	1	1	1	1	1	1
Grand Total	147	133	134	133	133	49	46	42	40	33	54	45	39	35	33

TABLE E: PRESENCE OF WORLD'S LARGEST 500 BANKS IN HONG KONG

Positions at 31.12.2005	Number of Overseas Bank ^(b)					Licensed Banks ^(c)				
	01	02	03	04	05	01	02	03	04	05
World Ranking ^(a)										
1-20	20	20	20	20	19	28	30	30	33	28
21-50	24	23	23	22	25	23	22	21	19	25
51-100	32	30	32	28	27	26	27	27	23	23
101-200	47	42	44	42	39	25	21	22	22	19
201-500	53	53	51	45	47	12	15	18	17	22
Sub-total	176	168	170	157	157	114	115	118	114	117
Others	73	51	44	52	51	33	18	16	19	16
Total	249	219	214	209	208	147	133	134	133	133

(a) Top 500 banks/banking groups in the world ranked by total assets less contra items. Figures are extracted from The Banker, July 2005 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices is greater than the number of overseas banks with a presence in Hong Kong because of the multiple presence of some overseas banks. The figures exclude banks incorporated in Hong Kong.

(c) Include subsidiaries of overseas banks, classified in accordance with the world ranking of these overseas banks.

Restricted Licence Banks ^(c)					Deposit-taking Companies ^(c)					Local Representative Offices				
01	02	03	04	05	01	02	03	04	05	01	02	03	04	05
11	12	11	10	5	6	4	3	1	1	8	7	7	7	8
5	3	4	5	5	–	–	–	–	–	8	7	4	4	5
3	4	4	4	4	3	5	2	2	3	11	6	6	5	5
4	2	3	3	2	6	5	5	4	3	17	19	23	22	21
14	13	10	7	5	7	8	7	5	3	30	24	22	20	21
37	34	32	29	21	22	22	17	12	10	74	63	62	58	60
12	12	10	11	12	32	23	22	23	23	37	31	25	27	26
49	46	42	40	33	54	45	39	35	33	111	94	87	85	86

**TABLE F : BALANCE SHEET:
ALL AUTHORIZED INSTITUTIONS AND RETAIL BANKS****All Authorized Institutions**

(HK\$ bn)

	2001		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,648	537	2,185
Inside Hong Kong ^(a)	1,626	252	1,879
Outside Hong Kong ^(b)	21	285	306
Interbank lending	397	2,231	2,628
Inside Hong Kong	287	182	468
Outside Hong Kong	111	2,049	2,160
Negotiable certificates of deposit (NCD)	87	40	128
Negotiable debt instruments, other than NCD	355	553	908
Other assets	231	74	306
Total assets	2,718	3,436	6,154
Liabilities			
Deposits from customers ^(c)	1,855	1,552	3,407
Interbank borrowing	454	1,474	1,929
Inside Hong Kong	290	180	470
Outside Hong Kong	164	1,295	1,459
Negotiable certificates of deposit	135	37	172
Other liabilities	473	173	646
Total liabilities	2,917	3,237	6,154

Retail Banks

(HK\$ bn)

	2001		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,304	150	1,454
Inside Hong Kong ^(a)	1,292	128	1,420
Outside Hong Kong ^(b)	12	22	33
Interbank lending	307	881	1,188
Inside Hong Kong	239	109	348
Outside Hong Kong	68	772	840
Negotiable certificates of deposit (NCD)	56	18	74
Negotiable debt instruments, other than NCD	256	360	616
Other assets	183	38	221
Total assets	2,106	1,447	3,553
Liabilities			
Deposits from customers ^(c)	1,688	1,020	2,708
Interbank borrowing	122	207	329
Inside Hong Kong	39	20	58
Outside Hong Kong	83	188	271
Negotiable certificates of deposit	85	28	113
Other liabilities	359	44	402
Total liabilities	2,254	1,299	3,553

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

2002			2003			2004			2005		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,616	461	2,076	1,573	462	2,035	1,667	489	2,156	1,797	515	2,312
1,591	243	1,834	1,542	267	1,809	1,631	291	1,923	1,749	323	2,072
25	218	243	31	195	226	36	198	233	48	192	240
332	1,983	2,315	438	2,175	2,614	447	2,577	3,024	434	2,457	2,891
236	159	395	295	177	472	291	185	476	227	182	410
96	1,823	1,919	144	1,998	2,142	156	2,392	2,548	206	2,275	2,481
90	44	134	86	58	144	74	48	121	66	32	97
395	715	1,109	397	800	1,197	459	870	1,328	436	934	1,370
255	110	365	289	212	501	296	212	508	314	264	578
2,687	3,312	5,999	2,783	3,708	6,491	2,943	4,195	7,138	3,047	4,202	7,248

1,825	1,493	3,318	1,931	1,636	3,567	2,018	1,848	3,866	2,132	1,936	4,068
384	1,404	1,788	428	1,489	1,918	439	1,711	2,150	409	1,555	1,965
236	157	394	285	185	470	296	203	499	229	184	414
147	1,246	1,394	143	1,305	1,448	143	1,508	1,651	180	1,371	1,551
138	73	211	132	110	242	124	132	256	131	132	263
509	173	683	495	268	764	609	256	865	626	327	952
2,856	3,143	5,999	2,987	3,504	6,491	3,191	3,947	7,138	3,298	3,950	7,248

2002			2003			2004			2005		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,307	151	1,459	1,278	172	1,450	1,371	200	1,571	1,510	215	1,725
1,296	130	1,426	1,266	146	1,412	1,354	159	1,513	1,483	160	1,643
11	22	33	12	26	39	17	41	58	27	55	83
245	765	1,010	330	836	1,166	302	1,022	1,324	266	982	1,248
190	107	297	247	110	358	235	117	352	175	101	276
56	658	713	83	726	809	67	905	972	91	881	972
61	21	82	58	38	96	55	28	83	50	20	71
259	484	744	278	565	843	317	583	900	315	639	954
208	61	269	233	78	312	244	99	343	242	122	364
2,081	1,483	3,564	2,178	1,689	3,867	2,289	1,932	4,220	2,383	1,979	4,362

1,663	1,063	2,726	1,786	1,141	2,927	1,874	1,270	3,144	1,916	1,326	3,242
78	213	291	90	265	354	89	295	384	100	264	364
24	31	55	31	26	58	38	30	68	55	38	93
54	182	236	58	238	296	51	265	316	45	226	271
86	52	138	82	80	162	80	99	179	85	97	182
365	44	409	361	63	424	434	79	513	464	111	575
2,193	1,372	3,564	2,319	1,548	3,867	2,477	1,743	4,220	2,565	1,797	4,362

TABLE G : MAJOR BALANCE SHEET ITEMS BY REGION/ECONOMY OF BENEFICIAL OWNERSHIP OF AUTHORIZED INSTITUTIONS

(HK\$ bn)

		Mainland					Total
		China	Japan	US	Europe	Others	
Total Assets	2004	1,146	576	650	1,877	2,889	7,138
	2005	1,181	550	681	1,803	3,033	7,248
Deposits from Customers	2004	836	178	291	541	2,019	3,866
	2005	842	155	315	642	2,114	4,068
Loans to Customers	2004	478	131	124	402	1,020	2,156
	2005	510	134	139	420	1,108	2,312
Loans to Customers Inside Hong Kong ^(a)	2004	446	84	116	310	967	1,923
	2005	468	102	130	331	1,041	2,072
Loans to Customers Outside Hong Kong ^(b)	2004	32	47	8	93	53	233
	2005	42	32	9	89	67	240

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

TABLE H : FLOW OF FUNDS FOR ALL AUTHORIZED INSTITUTIONS AND RETAIL BANKS

All Authorized Institutions

(HK\$ bn)	2004			2005		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Increase/(Decrease) in						
Assets						
Loans to customers	94	27	121	131	26	156
Inside Hong Kong ^(a)	89	25	114	118	31	149
Outside Hong Kong ^(b)	4	2	7	13	(6)	7
Interbank lending	9	401	410	(14)	(119)	(133)
Inside Hong Kong	(4)	8	4	(64)	(2)	(66)
Outside Hong Kong	12	394	406	50	(117)	(67)
All other assets	57	59	116	(13)	100	87
Total assets	159	488	647	104	6	110
Liabilities						
Deposits from customers ^(c)	87	212	299	114	88	202
Interbank borrowing	11	222	233	(30)	(156)	(186)
Inside Hong Kong	11	18	29	(67)	(19)	(86)
Outside Hong Kong	0	203	204	37	(137)	(100)
All other liabilities	106	9	115	24	70	94
Total liabilities	204	443	647	108	3	110
Net interbank borrowing/(lending)	2	(180)	(177)	(16)	(36)	(53)
Net customer lending/(borrowing)	7	(185)	(178)	17	(63)	(46)

Retail Banks

(HK\$ bn)	2004			2005		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Increase/(Decrease) in						
Assets						
Loans to customers	93	28	121	139	16	154
Inside Hong Kong ^(a)	88	13	102	129	1	130
Outside Hong Kong ^(b)	5	15	19	10	15	25
Interbank lending	(28)	185	157	(36)	(39)	(76)
Inside Hong Kong	(13)	7	(6)	(60)	(16)	(76)
Outside Hong Kong	(15)	178	163	24	(23)	0
All other assets	46	29	75	(9)	72	63
Total assets	111	242	353	94	48	142
Liabilities						
Deposits from customers ^(c)	88	129	217	42	56	98
Interbank borrowing	(1)	31	30	11	(32)	(21)
Inside Hong Kong	6	4	10	17	7	25
Outside Hong Kong	(7)	27	20	(6)	(39)	(45)
All other liabilities	71	35	106	35	30	64
Total liabilities	158	195	353	88	54	142
Net interbank borrowing/(lending)	27	(155)	(127)	48	8	55
Net customer lending/(borrowing)	5	(101)	(96)	97	(41)	56

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

TABLE I : LOANS TO AND DEPOSITS FROM CUSTOMERS BY CATEGORY OF AUTHORIZED INSTITUTIONS

(HK\$ bn)

	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
2001								
Licensed banks	1,507	521	2,028	93	1,838	1,528	3,367	99
Restricted licence banks	108	15	122	6	12	21	33	1
Deposit-taking companies	32	2	35	2	4	2	6	-
Total	1,648	537	2,185	100	1,855	1,552	3,407	100
2002								
Licensed banks	1,491	446	1,937	93	1,806	1,470	3,276	99
Restricted licence banks	99	13	112	5	15	21	36	1
Deposit-taking companies	26	2	27	1	4	2	6	-
Total	1,616	461	2,076	100	1,825	1,493	3,318	100
2003								
Licensed banks	1,465	448	1,913	94	1,916	1,608	3,524	99
Restricted licence banks	85	12	97	5	12	27	38	1
Deposit-taking companies	24	1	25	1	3	2	5	-
Total	1,573	462	2,035	100	1,931	1,636	3,567	100
2004								
Licensed banks	1,581	475	2,057	95	2,007	1,839	3,846	99
Restricted licence banks	67	12	79	4	8	7	15	-
Deposit-taking companies	19	2	21	1	3	2	5	-
Total	1,667	489	2,156	100	2,018	1,848	3,866	100
2005								
Licensed banks	1,750	500	2,250	97	2,116	1,927	4,043	99
Restricted licence banks	26	13	39	2	12	7	19	-
Deposit-taking companies	22	1	23	1	3	2	5	-
Total	1,797	515	2,312	100	2,132	1,936	4,068	100

(a) Hong Kong dollar customer deposits include swap deposits.

A "-" sign denotes a figure of less than 0.5.

Figures may not add up to total due to rounding.

TABLE J: LOANS TO CUSTOMERS INSIDE HONG KONG BY ECONOMIC SECTOR

All Authorized Institutions

(HK\$ bn)	2001		2002		2003		2004		2005	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Sector										
Hong Kong's visible trade	89	5	91	5	100	6	130	7	142	7
Manufacturing	71	4	71	4	80	4	99	5	119	6
Transport & transport equipment	102	5	104	6	110	6	121	6	123	6
Building, construction & property development and investment	389	21	379	21	360	20	386	20	450	22
Wholesale and retail trade	101	5	100	5	94	5	99	5	101	5
Financial concerns (other than authorized institutions)	142	8	125	7	147	8	168	9	179	9
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	107	6	99	5	87	5	77	4	68	3
to purchase other residential property	540	29	542	30	529	29	534	28	539	26
other purposes	150	8	143	8	137	8	149	8	169	8
Others	188	10	178	10	164	9	158	8	183	9
Total ^(a)	1,879	100	1,834	100	1,809	100	1,923	100	2,072	100

Retail Banks

(HK\$ bn)	2001		2002		2003		2004		2005	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Sector										
Hong Kong's visible trade	69	5	72	5	80	6	103	7	115	7
Manufacturing	46	3	47	3	53	4	65	4	75	5
Transport & transport equipment	58	4	63	4	68	5	76	5	81	5
Building, construction & property development and investment	307	22	311	22	301	21	331	22	378	23
Wholesale and retail trade	68	5	70	5	65	5	67	4	69	4
Financial concerns (other than authorized institutions)	63	4	56	4	65	5	65	4	70	4
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	69	5	65	5	57	4	51	3	68	4
to purchase other residential property	497	35	508	36	501	35	515	34	526	32
other purposes	116	8	111	8	104	7	126	8	140	9
Others	126	9	122	9	117	8	113	7	120	7
Total ^(a)	1,420	100	1,426	100	1,412	100	1,513	100	1,643	100

(a) Defined as loans for use in Hong Kong plus trade-financing loans. Figures may not add up to total due to rounding.

TABLE K: DEPOSITS FROM CUSTOMERS

(HK\$ bn)	All Authorized Institutions				Retail Banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
2001	128	614	1,113	1,855	117	608	963	1,688
2002	146	674	1,004	1,825	134	668	861	1,663
2003	227	936	768	1,931	203	927	656	1,786
2004	272	1,033	713	2,018	250	1,023	601	1,874
2005	206	742	1,183	2,132	190	734	992	1,916
Foreign Currency								
2001	28	238	1,286	1,552	20	214	786	1,020
2002	36	272	1,184	1,493	24	245	794	1,063
2003	59	341	1,236	1,636	38	307	796	1,141
2004	72	399	1,378	1,848	47	357	866	1,270
2005	86	402	1,448	1,936	56	353	917	1,326
Total								
2001	156	851	2,399	3,407	137	822	1,749	2,708
2002	182	946	2,189	3,318	158	913	1,656	2,726
2003	286	1,278	2,004	3,567	241	1,234	1,452	2,927
2004	344	1,432	2,090	3,866	297	1,379	1,468	3,144
2005	292	1,144	2,631	4,068	246	1,087	1,909	3,242

(a) Hong Kong dollar customer deposits include swap deposits.
Figures may not add up to total due to rounding.

TABLE L: GEOGRAPHICAL BREAKDOWN OF NET EXTERNAL CLAIMS/(LIABILITIES) OF ALL AUTHORIZED INSTITUTIONS

(HK\$ bn) Region/Economy	2004			2005		
	Net Claims on/ (Liabilities to)		Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to)		Total Net Claims/ (Liabilities)
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Non-bank Customers Outside Hong Kong		Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Non-bank Customers Outside Hong Kong	
Asia & Pacific	573	(122)	451	531	(158)	373
Singapore	276	(48)	228	299	(53)	246
Australia	179	26	204	186	24	210
Japan	185	35	220	84	23	107
South Korea	(3)	20	17	57	20	76
India	9	8	17	10	6	16
New Zealand	12	1	13	10	2	12
Malaysia	(3)	14	11	(5)	12	7
Republic of Kazakhstan	0	0	1	1	0	1
Bangladesh	0	0	0	1	0	1
Sri Lanka	(1)	0	(1)	1	0	1
Vietnam	0	(1)	(1)	0	0	0
Pakistan	0	0	0	(1)	0	0
Laos	0	0	0	0	(1)	(1)
Vanuatu	0	(1)	(1)	0	(1)	(1)
Western Samoa	0	(2)	(2)	0	(3)	(3)
Philippines	(2)	(7)	(9)	(4)	(5)	(9)
Indonesia	(3)	(3)	(5)	(7)	(3)	(10)
Brunei	(3)	0	(3)	(10)	(1)	(10)
Thailand	(12)	(1)	(13)	(12)	(3)	(16)
Taiwan	26	(57)	(31)	34	(70)	(36)
Macau SAR	(42)	(9)	(51)	(51)	(12)	(63)
Mainland China	(44)	(97)	(140)	(61)	(90)	(151)
Others	0	(1)	(1)	0	(2)	(2)
North America	121	131	252	143	120	263
United States	91	122	213	110	118	228
Canada	30	9	39	33	2	36
Caribbean	11	(39)	(27)	4	0	4
Cayman Islands	19	(38)	(19)	17	5	22
Bermuda	0	4	4	0	2	2
Panama	0	0	1	0	(1)	(1)
Netherlands Antilles	1	(6)	(5)	2	(3)	(2)
Bahamas	(8)	(6)	(14)	(14)	(7)	(22)
Others	0	7	6	0	4	5
Africa	(3)	(1)	(5)	(13)	(2)	(15)
Liberia	0	(1)	(1)	0	0	0
Mauritius	(3)	(1)	(4)	(13)	(1)	(14)
Others	0	0	0	0	0	0

TABLE L: GEOGRAPHICAL BREAKDOWN OF NET EXTERNAL CLAIMS/(LIABILITIES) OF ALL AUTHORIZED INSTITUTIONS (cont.)

(HK\$ bn) Region/Economy	2004			2005		
	Net Claims on/ (Liabilities to)		Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to)		Total Net Claims/ (Liabilities)
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Non-bank Customers Outside Hong Kong		Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Non-bank Customers Outside Hong Kong	
Latin America	2	(1)	0	2	(2)	0
Brazil	1	0	1	2	(1)	1
Chile	0	1	1	0	1	1
Venezuela	0	(1)	(1)	0	(1)	(1)
Others	0	0	0	0	(1)	(1)
Eastern Europe	1	0	1	1	0	1
Western Europe	790	43	833	916	48	965
United Kingdom	347	1	348	403	(2)	401
France	132	13	145	149	5	154
Netherlands	66	13	78	90	15	105
Switzerland	39	(2)	36	58	(2)	56
Belgium	39	1	40	51	(1)	50
Germany	24	4	29	34	4	39
Italy	32	7	40	27	12	39
Denmark	13	0	13	27	0	27
Sweden	25	3	28	17	4	21
Republic of Ireland	11	1	11	21	(5)	17
Norway	16	2	18	14	2	15
Austria	11	0	11	14	0	14
Finland	5	0	5	7	0	7
Luxembourg	17	0	17	(7)	13	6
Spain	9	0	9	5	0	5
Iceland	2	0	2	4	0	4
Portugal	2	0	2	2	0	2
Greece	(1)	1	1	0	1	1
Guernsey	(1)	2	1	(1)	2	1
Jersey	0	(1)	(1)	0	1	1
Others	1	(1)	0	0	0	0
Middle East	9	1	10	(6)	4	(1)
United Arab Emirates	1	1	1	0	4	4
Saudi Arabia	0	0	0	1	0	1
Kuwait	0	0	0	0	1	1
Iran	(1)	0	(1)	(1)	0	(1)
Oman	0	0	0	(1)	0	(1)
Israel	0	0	0	(2)	0	(2)
Bahrain	10	0	10	(4)	0	(4)
Others	0	0	0	0	0	0
Others ^(a)	36	0	36	14	0	14
Overall Total	1,539	12	1,551	1,593	11	1,604

(a) "Others" include economies not listed in the above and position in relation to international organisations.

ABBREVIATIONS USED IN THIS REPORT

ABF	- Asian Bond Fund	HIBOR	- Hong Kong Interbank Offer Rate
ABF1	- US dollar-denominated Asian Bond Fund	HKAB	- Hong Kong Association of Banks
ABF2	- Local currency-denominated Asian Bond Fund	HKAS	- Hong Kong Accounting Standard
ACIHK	- The Financial Markets Association of Hong Kong	HKICL	- Hong Kong Interbank Clearing Limited
AI	- Authorized institution	HKSAR	- Hong Kong Special Administrative Region
APEC	- Asia-Pacific Economic Co-operation	IMF	- International Monetary Fund
ATM	- Automated teller machine	IRB	- Internal Ratings-based Approach
bn	- billion	IT	- Information technology
CAMEL	- Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks	JETCO	- Joint Electronic Teller Company Limited
CAR	- Capital Adequacy Ratio	MDB	- Multilateral Development Bank
CBRC	- China Banking Regulatory Commission	mn	- million
CCASS	- Central Clearing and Settlement System	MPF	- Mandatory Provident Fund
CCPI	- Composite Consumer Price Index	MPFA	- Mandatory Provident Fund Scheme Authority
CCRA	- Commercial Credit Reference Agency	N.A.	- not applicable
CEPA	- Closer Economic Partnership Arrangement	NCD	- Negotiable certificate of deposit
CHATS	- Clearing House Automated Transfer System	NDI	- Negotiable debt instrument
CLS	- Continuous Linked Settlement	OECD	- Organisation for Economic Co-operation and Development
CMU	- Central Moneymarkets Unit	OGC	- The Office of the General Counsel
CPI	- Consumer Price Index	PAIF	- Pan-Asian Bond Index Fund
CSSO	- Clearing and Settlement Systems Ordinance	PBoC	- People's Bank of China
DCA	- Debt collection agency	PvP	- Payment-versus-Payment
DvP	- Delivery-versus-Payment	RI	- Registered Institutions
EFAC	- Exchange Fund Advisory Committee	RMB	- Renminbi
EFBN	- Exchange Fund Bills and Notes	RTGS	- Real Time Gross Settlement
EMEAP	- Executives' Meeting of East Asia-Pacific Central Banks	S&P 500	- Standard & Poor's 500
EPS	- Easy Pay System	SAR	- Special Administrative Region
GDP	- Gross Domestic Product (in real terms unless otherwise stated)	SFC	- Securities and Futures Commission
		SPM	- Supervisory Policy Manual
		STET	- Submission Through Electronic Transmission
		SWIFT	- Society for Worldwide Interbank Financial Telecommunication
		TMA	- Treasury Markets Association
		TMF	- Treasury Markets Forum
		TOPIX	- Tokyo Stock Price Index

REFERENCE RESOURCES

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Second Edition)

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System

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HKMA Background Brief No. 2 – Banking Supervision in Hong Kong

Money and Banking in Hong Kong: A Historical Timeline

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Educational leaflets on various topics including notes and coins and banking issues

HKMA publications may be purchased or obtained from the **HKMA Information Centre**, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. The HKMA Information Centre consists of an Exhibition Area and a Library. The Centre introduces the work of the HKMA and houses books, journals and other texts on central banking and related subjects. The Centre is open to the public six days a week.

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Most HKMA publications are also available for download free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

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The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

 > [Legislative Council Issues](#)

The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research memoranda, and features on topical issues.

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